Chapter 6: Consumer Financial Protection Principles

The NCCF identified four overarching principles for a well-functioning, efficient, and fair consumer credit system: (1) To protect consumers from "excesses" by financial services providers, (2) to empower consumers by providing them with information to shop more effectively for the products they desire and to facilitate competition, (3) to instill competition as "the key ingredient of a finance industry capable of providing an adequate supply of at reasonable rates," and (4) to promote access for all consumers to quality financial services.[1] These four basic orienting principles—consumer protection, information, competition, and inclusion—remain equally valid today as they did fifty years ago.

Part II of the Taskforce Report examines the core principles of consumer financial protection, starting in this chapter with consumer protection principles. Analysis of information provision as consumer protection through disclosures of terms and other means will be the focus of Chapter 7 of this Report. Competition will be the focus of Chapter 8 of this report. Chapter 9 focuses on innovation, which cuts across competition, inclusion, information, and consumer protection. Inclusion and access will be the focus of Chapter 10.

This Chapter of the Report focuses on the question of consumer protection. It is a propitious time to review the consumer protection regime with respect to financial services. In the fifty years since the NCCF Report, there have been profound changes to the federal consumer financial protection ecosystem. From the modest beginnings with

[1] REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 2 (Dec. 1972).

the Truth-In-Lending Act in the late 1960s, numerous laws and regulations have been layered atop each other. Interstate branch banking has been legalized and credit card interest rates and other price terms have largely been deregulated. At the time of the NCCF Report, general purpose credit cards were a relatively new product and the consumer finance economy was becoming increasingly national in scope and operation; today, consumer payments, lending, and other transactions are increasingly conducted over the Internet. Technological innovation has created both new opportunities for consumer benefits but also potential new dangers, a trend that was accelerated by the global viral pandemic of 2020. Banking crises in the 1980s and 2000s, both rooted in residential mortgage markets, spawned large-scale regulatory reforms. And in 2008 the world experienced a financial meltdown related to residential mortgages that raised calls for new regulations and new regulatory institutions. 2020 marked the tenth anniversary of the passage of the Dodd-Frank financial regulation law and established the CFPB.

This Chapter focuses on several elements of the consumer protection question. First, it briefly reviews the history of consumer financial protection legislation and regulation in the United States, with a particular focus on the growing role of the federal government in consumer financial protection over time. Second, it identifies the fundamental objectives of a well-functioning consumer financial protection regime and the institutional framework for its implementation. Third, the Chapter examines the criteria for intervention by regulatory agencies, with special focus on the CFPB. Finally, the Chapter examines the CFPB's regulatory tools to analyze the particular roles that each of those tools can and should play and how to use those tools in a coordinated fashion to construct an optimal consumer financial protection regulatory regime.

I. Historical Background: State and Federal Regulation

In the United States, consumer financial protection historically was governed primarily at the state level. Moreover, the traditional approach to consumer financial protection was largely in the nature of *substantive* regulations, meaning direct regulation of the products that are offered, including regulation of interest rates, loan sizes, and other product features. The primary method of regulation at the state level was the establishment of maximum interest rate ceilings, known historically as "usury" regulations, as well as other substantive regulation of terms and conditions of financial products, such as maximum loan sizes and restrictions on competition and new entry.[2]

As an historic matter, the federal government had a minimal direct role in consumer financial protection for most consumers and most products for most of ~~US~~ American history. The federal role was not nonexistent, but its consumer protection function was largely a byproduct of its supervisory authority over federally ~~-~~chartered depository institutions and savings and loans. Where the federal government used substantive controls on consumer financial products such as maximum interest rates on savings accounts, it was usually to promote certain economic or other policy goals, such as controlling interest rates, initially to subsidize wartime financing, but then continuing interest rate controls after the war to promote the housing market, and still later as a complement to monetary policy efforts to control inflation. The Federal Trade Commission also enforced federal law against unfair and deceptive acts and practices involving consumer financial services. The federal government's role in consumer

[2] Usury regulations are discussed in greater detail in chapters 5 and 10.

financial protection expanded beginning in the 1960s and has grown dramatically since that time.[3]

Government regulation of consumer financial products and services is as old as credit itself.[4] The primary focus of consumer credit regulations was the imposition of price ceilings on the interest rate that could be charged on loans, historically known as "usury" ceilings. Many states also imposed limitations on the remedies available to creditors in the event of the debtor's default.[5] For example, many states abolished imprisonment for debt during the first half of the Nineteenth Century. Often the two elements would go together, as stricter interest rate ceilings often were associated with more lenient regulation of remedies that were available to creditors upon default.

Economists have long been critical of usury ceilings, dating at least to Jeremy Bentham's famous tract, *In Defense of Usury*.[6] By the time of the NCCF, the expert consensus was that despite the historic ubiquity of usury ceilings and other substantive regulations through history, the costs of those restrictions substantially exceeded the benefits for consumers and the economy.[7] Moreover, it was recognized that those costs fell most heavily on lower-income and higher-risk consumers, who were forced to pay higher prices for the goods that they purchased, had access to less competitive credit

[3] An extensive discussion of the history of state and federal regulation is available in THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014), especially chapters 10 and 11.
[4] For example, the Code of Hammurabi (1750 BC) included limits on the interest rate that could be charged on loans. *See* THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY 483 (2014).
[5] For example, in addition to limiting interest rates, the Code of Hammurabi also placed limits on creditor's remedies. Many traditional remedies were barbaric compared to what are currently known as remedies for default. *Id.* at 484.
[6] *See, e.g.*, JEREMY BENTHAM, IN DEFENSE OF USURY (1818).
[7] The underlying economic analysis of usury regulations is discussed in detail in chapters 5 and 10 of this Report. The brief discussion here is designed to illuminate the intellectual context that shaped the NCCF's deliberations and research efforts.

markets, and in at least some instances, were forced into the hands of illegal loan sharks. Paul Samuelson, the first American to be awarded the Nobel Prize in Economics, testified before the Massachusetts State Legislature in 1969 in arguing for the elimination of usury ceilings on consumer credit:

> The concern for the consumer and for the less affluent is well taken. But often it has been expressed in a form that has done the consumer more harm than good. For fifty years the Russell Sage Foundation and others have demonstrated that setting too low ceilings on small loan interest rates will result in drying up legitimate funds to the poor who need it most and will send them into the hands of the illegal loan sharks. History is replete with cases where loan sharks have lobbied in legislatures for unrealistic minimum rates, knowing that such meaningless ceilings would permit them to charge much higher rates.[8]

And fellow Nobel Laureate economist Milton Friedman similarly observed in 1970, "I know of no economist of any standing from [Bentham's] time to this who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive…."[9]

As underlying interest rates rose and inflation soared during the 1970s, the distortionary effects and economic and social harm created by usury ceilings became increasingly apparent. As a result, expert opinion turned sharply against the wisdom of traditional usury ceilings and other substantive command-and-control style regulations as a mechanism for consumer financial protection.

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A. The Evolution of Federal Regulation

At the same time that evolving economic trends were exposing the costs of substantive regulation, the post-War American economy was becoming increasingly

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[8] Statement by Dr. Paul A. Samuelson Before the Committee of the Judiciary Of the General Court of Massachusetts in Support of the Uniform Consumer Credit Code, *reprinted in* STATEMENTS OF FORMER SENATOR PAUL DOUGLAS AND PROFESSOR PAUL SAMUELSON ON THE UNIFORM CONSUMER CREDIT CODE 7, 8 (National Conference of Commissioners on Uniform State Laws, Jan. 29, 1969).
[9] Milton Friedman, *In Defense of Usury*, NEWSWEEK (Apr. 6, 1970).

national in scope, fueled by falling transportation and communication costs. As discussed in chapter 3, the post-War prosperity and great migration of Americans to the suburbs in the post-War era fueled an explosion of demand for automobiles, furniture, appliances, and other consumer durables, which in turn fueled a rapid increase in demand for consumer credit. The American population grew and became more mobile. Interstate migration and technological improvements that enabled financial products to be offered across state lines more easily (such as declining long-distance telephone rates) also made the consumer finance market ~~also became~~ more national in scope. Regional and national department store chains grew, with retail operations in multiple states.[10] As those regional and national chains grew, merging with or eliminating smaller rivals, those chains centralized their credit operations in their headquarters while operating under the rules of multiple ~~different~~ states.[11]

In the decades following World War II, banks were limited by branching restrictions from expanding beyond their home state. Beginning in the 1950s and expanding into the 1960s, however, bank-issued credit card became more widespread,

[10] Some department store chains, most notably Sears and Roebuck, already had national footprints but interstate department store chains were anomalous in the pre-War era. Large chains accounted for less than 15 percent of department store sales in 1929 but nearly 80 percent of department store sales by 1972. *See* Robert M. Hunt, *Development and Regulations of Consumer Credit Reporting in the United States*, *in* THE ECONOMICS OF CONSUMER CREDIT 301, 310 (Guiseppe Bertola, Richard Disney, and Charles Grant eds., 2006).

[11] Today a similar wave of is overtaking retailing that has accelerated these trends. By the First Quarter of 2020, over 11 percent of retails sales were made online, a figure that jumped to over 16 percent in the Second Quarter as retail stores were shuttered as a result of government responses in many states to the viral pandemic at the time. *See E-Commerce Retail Sales as a Percent of Total Sales*, FED. RES. BANK OF ST. LOUIS ECONOMIC RESEARCH, *available in* [HYPERLINK "https://fred.stlouisfed.org/series/ECOMPCTSA"]. Regulations in many states that permitted vendors of "essential" consumer goods to remain open while other retailers were forcibly closed also accelerated the trend toward a greater share of bricks-and-mortar retail being provided by large interstate "big box" retailers that sold those items as well others. *See* The Real Deal, *A Few Big-Box Stores Now Account for 29% of US Sales*, THEREALDEAL.COM (Aug. 25, 2020), *available in* [HYPERLINK "https://therealdeal.com/2020/08/25/a-few-big-box-stores-now-account-for-29-of-us-sales/"].

conducting their operations primarily through the mail and telephone, not through a traditional bank branch network.

The growth of national consumer finance markets created increasing pressures for a greater federal presence in consumer financial protection law. An example is provided by the regulation of debt collection operations. Unfair and abusive debt collection practices traditionally were regulated at the state and local level as many of the major consumer protection concerns dealt with in-person harassment and similar activities by creditors. As the price of long distance telephone calls fell through the 1960s, however, debt collectors increasingly operated across state lines, rendering local regulation and enforcement increasingly ineffective and cumbersome.[12] National credit reporting agencies evolved to meet the needs of this growing national market and the decline in localized personal banking relationships, raising additional novel consumer protection issues regarding consumer privacy and information.[13]

The interstate nature of these developments challenged traditional state-based jurisdictional boundaries, giving rise to increasing calls for a larger federal role in consumer financial protection. But at the same time, the growing consensus on the baleful effects of usury and similar regulations on consumers and the economy generated calls for a different approach, where possible, to consumer financial protection. That new approach "initiated a fundamentally new approach to financial consumer protection," namely "extensive required disclosures to consumer[s] of transaction-specific information."[14] To be sure, many states also had disclosure laws of one form of another

[12] *See* Todd J. Zywicki, *The Law and Economics of Debt Collection and Its Regulation*, 28 LOYOLA CONSUMER L. J. 167 (2016).
[13] *See* Hunt, *supra* note 10; *see also* chapter 11 of this report.
[14] DURKIN, ET AL., CONSUMER CREDIT, *supra* note [NOTEREF _Ref54725425 \h], at 453.

that supplemented substantive rules.[15] "Before that time," however, "consumer protection in the credit area had been state responsibility, and states had been interested primarily in establishing and enforcing credit price ceilings within their boundaries (usury laws) and in licensing the providers of credit and circumscribing certain practices considered objectionable."[16]

As crystallized in the NCCF's report, which represented the consensus view at the time, the organizing principles of the modern consumer credit regulatory system was founded on the principle of robust competition and consumer choice as the first goal of consumer financial protection and the primary focus of regulation should be to make markets work better for consumers by increasing transparency, competition, and consumer choice. The enactment of the Truth in Lending Act in 1968 marks the beginning of a new era of disclosure-based regulation that focuses on providing consumers with relevant information that will enable them to make better decisions and promote robust competition and consumer choice. Several similar regulations followed later, such as the Truth in Leasing Act in 1976 (implemented by Regulation M), Truth in Savings Act in 1991 (with Regulation DD). A defining characteristic of new federal regulation was growing skepticism of price controls on interest rates and other terms and conditions of consumer financial products. In addition, new substantive legislation and regulation was enacted where there was a perception that markets failed to work fairly and efficiently and information-based and existing state regulation were inadequate to address those problems. This second category included areas such as discrimination (the Equal Credit Opportunity Act and Fair Housing Act), where it was perceived that market

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[15] *See* NCCF Report, *supra* note [NOTEREF _Ref54725517 \h], at 170-71 (discussing state predecessors).
[16] DURKIN, ET AL., CONSUMER CREDIT, *supra* note [NOTEREF _Ref54725425 \h], at 453.

processes had failed to adequately eliminate discriminatory practices, and various regulations on credit reporting (the Fair Credit Reporting Act), debt collection (Fair Debt Collection Practices Act), and other markets where various market incentives and constraints were not aligned to promote consumer welfare and thus information-based remedies would be inadequate. Many of these substantive regulations also had disclosure remedies attached to them.

As the NCCF observed, the logic of usury ceilings and other substantive regulation of terms and conditions of financial products fundamentally rests on the idea that politicians can determine better than the free interaction of consumers and financial service providers operating in competitive markets "who should get credit, how much credit, what kind of credit, and at what price."[17] The Commission concluded that it could "devise no empirical method"[18] for answering those questions any more than it could establish whether the "price of a hamburger or shoes was 'fair' at any given time, or that more of either might be better."[19] To answer those questions throughout the rest of the economy:

> [W]e look toward a marketplace. If sufficient alternative sources compete for patronage, it is assumed that the price and supply are 'fair', because they are set by free competitive forces. The Commission perceives no reason to assume that—in general—competition will not have the same result in the consumer credit area.[20]

The NCCF's criticism of traditional state regulatory approaches was severe and unflinching, noting that state legislation "tended to restrain competition and unnecessarily segment the consumer credit market" and noting numerous examples such as "unrealistic

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[17] NCCF Report, *supra* note [NOTEREF _Ref54725517 \h], at 2.
[18] *Id.*
[19] *Id.* at 3.
[20] *Id.* at 3

rate structures" and limits on the products that particular types of entities could offer to consumers.

Instead, the NCCF identified three legitimate functions for regulation in the field of consumer credit:

> (1) to promote and assure the maintenance of what the Commission deems to be the key ingredient of a finance industry capable of providing an adequate supply of credit at reasonable rates—competition among numerous alternate sources of credit; (2) to assure access *by all* to these alternate sources of credit; and (3) to prevent excesses which the "system" may invoke against the borrower.[21]

Moreover, "to assure that competition is meaningful," the NCCF endorsed a fourth goal of empowering consumers through providing information that could be used to promote competition and shop among different products and providers.

Finally, the Commission singled out for special criticism the deleterious effects of traditional state price-control laws on access by low-income consumers and others to competitive financial markets:

> The foregoing then, constitutes the Commission's overall recommended legislative and regulatory approach; removal of impediments and barriers, manmade and statemade, to the operation of competitive forces, proposals to assist vigilant legislatures and regulators to combat monopoly and restrictive practices, elimination of market excesses, and continued efforts to assure that the consumer will have full knowledge of his credit transactions, thereby permitting rates to be set by workable competition in the marketplace.[22]

These four principles: (1) Competition, (2) Inclusion, (3) Consumer Protection, and (4) Information remain the fundamental organizing principles of the US consumer financial protection system.

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[21] NCCF Report, *supra* note [NOTEREF _Ref54725517 \h], at 2.
[22] *Id.*

The world around consumer finance has changed dramatically in the past fifty years. Nevertheless, the current Taskforce enthusiastically endorses and recognizes the continued centrality of these four goals as the foundation of a well-functioning consumer financial protection system. To this list the Taskforce adds a fifth theme—the need to create a more adaptable and flexible institutional framework that will enable the consumer financial protection regulatory regime that can adapt more swiftly and effectively to changes in the consumer finance landscape[23]. Indeed, Part II of this Report comprising chapters 6-10, will follow this analytical structure. This Chapter develops and updates the relevance of those principles for the modern era, including principles for protecting consumers from "market excesses" and other market failures. Chapter 7 will focus on the importance of information and disclosure-based remedies for making markets work, and lessons learned from the experience with disclosure regulation since the enactment of Truth in Lending. Chapter 8 will turn to the competitive landscape of consumer financial services, and as with the NCCF Report, the discussion will focus on both clearing away regulatory barriers to competition as well as proposals for making competition work better. Chapter 9 will focus on the particular role of innovation in promoting competition, consumer choice, and inclusion. Chapter 10 will turn to the principle of access and inclusion. And Chapter 13 will provide an overview of the consumer financial protection institutional landscape and ideas for reform to improve its flexibility and adaptability to rapidly -changing circumstances in the digital age.

The first foray of the federal government into the realm of consumer financial protection approximately fifty years ago was driven by the growing difficulties associated with the traditional system of substantive regulation of terms and conditions of credit and

[23] This will be discussed in chapter 13.

the growing difficulties confronting ~~of~~ state regulators in an increasingly national consumer finance economy. Today that problem has grown multifold as a result of the Internet—not only is the economy national in scope, it is global. Even federal jurisdiction finds itself challenged to keep up with increasingly novel products and delivery mechanisms of the modern financial system. But while these innovations provide great promise for consumers, they also potentially raise new concerns, or in some instances, perceived concerns.

What should be the role and function of consumer financial protection in the Twenty-First Century?

B. Dodd-Frank, the Consumer Financial Protection Bureau, and the Principles of a Modern Federal Consumer Financial Protection System

The 2008 Financial Crisis and the legislative and regulatory response upended the traditional federal-state relationship as well as the traditional federal focus on disclosure regulation as opposed to substantive rules. The Dodd-Frank Wall Street ~~Financial~~ Reform and Consumer Protection Act, enacted in the wake of the financial crisis, included among its provisions several new substantive rules and regulations governing consumer financial products and services. More far-reaching, however, Dodd-Frank created the new Bureau of Consumer Financial Protection (which ~~have~~ has generally come to be known as the Consumer Financial Protection Bureau or "CFPB"), based in the Federal Reserve. The mandate of the CFPB is broad and overlaps many areas of traditional state jurisdiction as well as several other federal regulatory bodies. Equally important, it is clear that the mandate of the CFPB provides it with both the mission and resources to enlarge the federal government's role in consumer financial protection.

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The idea of a federal consumer financial protection agency was not a new one. Indeed, among the NCCF's recommendations was the creation of a new federal Consumer Protection Agency ("CPA") that would replace the Federal Trade Commission as the primary federal consumer financial protection regulatory agency for all consumer protection issues among which would be a Bureau of Consumer Credit ("BCC").[24] Failing the creation of a new larger consumer protection agency with a dedicated consumer credit bureau, the NCCF recommended the creation of a stand-alone consumer financial protection agency. According to the NCCF, the BCC, whether as a stand-alone entity or part of a larger agency, would be charged with the promulgation and enforcement of consumer protection laws, but also to monitor and promote competition and inclusion for the benefit of consumers.[25]

The NCCF also called for the federal government to take the lead in modernizing state laws that interfered with competition and consumer access. To further the goals of promoting consumer protection, competition, and financial inclusion, the NCCF recommended that if the states would not willingly remove usury restrictions and barriers to competition that harmed consumers and interfered with financial inclusion, federal action should be considered to preempt those laws. The Report states:

> Finally, the Commission fails to see why every citizen of the United States is not entitled to qualify for participation in some part of the credit system herein advocated. It can find no validity in the proposition that when the legislature of a particular state refuses to move away from anachronistic notions, its citizens should suffer deprivation of credit afforded others of equal standing. Accordingly, the commission urges as its first choice the adoption of state laws deigned both to assure fair treatment of all consumers and to give all credit grantors equal opportunity to compete.

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[24] *See* NCCF Report, *supra* note [NOTEREF _Ref54725517 \h], at 58.
[25] *See id.* at 59.

Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal.[26]

In addition, the NCCF stated, "If barriers to competition in the consumer credit market are not eliminated, federally chartered finance companies should be established utilizing the BCC as the chartering and supervisory agency."[27] Among the benefits of the federal charter identified by the NCCF was the ability to override archaic state usury ceilings and state "convenience and advantage" laws that erected barriers to entry against new competitors. The NCCF concluded, however, that it would be better for the federal government to first try to persuade the states to remove these anachronistic and harmful laws before considering any action to preempt them, but did not rule out preemption if the states failed to do so. Despite the NCCF's hope that states would phase out their usury laws on their own, state laws remain a patchwork of rules and exceptions and many states retain usury laws for many consumer financial products.[28]

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Thus, the idea of a federal regulatory body charged with a consumer financial protection mission was not novel when it was created in the wake of the 2008 financial crisis. Notably, the NCCF's first choice was the creation of a general federal consumer financial protection agency that contained a bureau of consumer credit within it.[29] Like the NCCF's proposed agency, the CFPB is also charged with a multi-pronged mission of

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[26] *Id.* at 4.
[27] *Id.* at 59.
[28] It is difficult to find a general summation of usury regulations. For one recent effort to collect and summarize state usury laws for small dollar loans in a simplified format, *see* [HYPERLINK "https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/FactSheet-StateRateCap.pdf"].; *see also* [HYPERLINK "https://www.cuna.org/uploadedFiles/Advocacy/Priorities/State_Government_Affairs/a-z_usury_lawguide.pdf"] (more extensive treatment of state usury laws).
[29] This resembles proposals that would have done what Congress did with the creation of the CFPB, namely to collect all consumer financial protection authority within one federal agency, but not to create an agency dedicated to *just* consumer financial protection but for consumer protection more generally. *See, e.g.*, Alden F. Abbott and Todd J. Zywicki, *How Congress Should Protect Consumers' Finances*, *in* PROSPERITY UNLEASHED: SMARTER FINANCIAL REGULATION 287 (2017).

protecting consumers from improper practices and discrimination, information provision, modernizing the regulatory framework, promoting conditions for innovation and competition, and to facilitate access and inclusion[30]:

> (b) OBJECTIVES.—The Bureau is authorized to exercise its authorities under Federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services—
>
> (1) consumers are provided with timely and understandable information to make responsible decisions about financial transactions;
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> (2) consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;
>
> (3) outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;
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> (4) Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and
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> (5) markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

Despite all of these goals being part of Dodd-Frank's mandate for the CFPB, it is not clear to the Taskforce that the Bureau has dedicated the same degree of energy and attention toward facilitating inclusion, competition, and innovation, as it has to protecting consumers from improper practices. Several of the Taskforce's recommendations focus on the ways in which Congress, the CFPB, and other regulatory agencies can act to promote those goals.

Although the concept of collecting the federal government's consumer financial protection mission in one regulatory body is not new, the scope of authority and resources dedicated to the CFPB are. The CFPB's rulemaking authority is far broader than held by prior federal consumer protection agencies such as the FTC. In the period

[30] 12 U.S.C. §5511(b).

since its creation, the CFPB has taken its charge to engage in substantive regulation aggressively. Some of these rulemaking and actions were mandated by Congress in Dodd-Frank, such as the requirement that the CFPB issue new rules governing "Qualified Mortgages" and a consumer's "Ability-to-Repay" mortgages as well as initially defining "larger ~~market~~ participants" ~~for~~ in ~~several~~ consumer financial markets. Other rulemakings, by contrast, were discretionary, such as rules that provided new substantive underwriting regulations on small-dollar loans, a ban on class action waivers in contractual arbitration agreements (later rescinded by a Congressional Review Act resolution), ~~a rule on financial remittances,~~ and updated regulations on debt collection practices, to name a few. Regardless of whether the rulemakings were required or discretionary, however, the end result was a large increase in substantive regulation by the federal government.

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Dodd-Frank and the CFPB also added new regulatory tools to the federal regulatory apparatus. Enforcement of federal consumer financial protection laws had always been present, mostly through the Federal Trade Commission and Department of Justice. Prudential regulators examined regulated entities for compliance with consumer protection laws and could issue penalties for violations. But enforcement, supervision, and regulation were patchwork affairs and often led to inconsistency and incoherence in consumer financial protection law.[31] Moreover, many products, services, and providers were regulated primarily at the state level with only sporadic and ad hoc intervention by federal regulators. This led to incoherent and inconsistent regulation of products that undermined competition by treating differently products that consumers view as close

[31] *See* Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 GEO. WASH. L. REV. 856 (2013) (explaining the need for increasing coherence of federal consumer financial protection regulatory regime and the supporting concept of uniting federal authorities in one regulatory authority).

substitutes for one another.[32] Dodd-Frank empowered the CFPB with broad enforcement resources and broad authority to enforce not only most enumerated federal consumer financial protection laws, but also expansive authority to prohibit any practices that are ~~considered~~ unfair, deceptive, or "abusive." Although the terms "unfair" and "deceptive" have developed longstanding and somewhat determinate meaning over decades of usage at the FTC, the term "abusive" seems to be a wholly novel term with no clear predicate meaning in law.[33]

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To this enhanced enforcement power, the CFPB was also given authority to engage in supervision of entities that meet certain definitional classifications and asset thresholds in the law. Although many states had differing degrees of inspection and examination of state-chartered institutions, the acquisition of extensive supervisory authority for the specific purpose of enforcing consumer protection laws appears to be novel within the consumer protection regulatory sphere in the United States. Supervision is today the largest single division of the CFPB and the B~~b~~ureau exercises supervision not only of traditional depository institutions and credit unions (where it shares authority for ~~larger institutions~~ with prudential regulators) but also "~~large~~ participants" in most other areas of the consumer financial ecosystem, including small-dollar lenders, debt collectors, and others. Finally, the CFPB also has other tools and powers designed to

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[32] For example, payday loans and bank overdraft protection are close substitutes for many credit-rationed consumers. Yet payday loans historically have been regulated by states under a licensing and enforcement model whereas overdraft protection has been regulated by the federal government largely under a supervision model. Thus, although consumer welfare would be maximized by treating payday lending and overdraft protection as part of a shared product space for purposes of consumer choice, policies between the two have largely been disjointed and uncoordinated. *See* Robert L. Clarke and Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. OF BANKING AND FIN. LAW. 235 (2013-2014).

[33] The CFPB held a symposium in 2019 to consider the definition of the term "abusive" and later issued a policy statement in fall 2019 that provides a definition of the term. To date, the policy statement has not yet been invoked in any enforcement or rulemaking action and it is unclear to what extent the CFPB will ~~treat~~ follow it ~~as binding on its authority~~.

protect consumers, including an active office of consumer education, a public-facing consumer complaint data base, and an office of research staffed largely by economists.

Thus, the creation of the CFPB marks a sharp break with the past in terms of the substantive role of the federal government with respect to consumer financial protection as well as the resources and powers to implement them. Moreover, the CFPB possesses a range of "tools" that previously were nonexistent, limited, or spread out among different consumer protection agencies in the federal government. These tools include: (1) Enforcement, (2) Supervision, (3) Rulemaking, (4) Education, and (5) Research.[34]

This chapter of the Report analyzes the principles of effective consumer protection regulation with a focus on the application of those principles to the consumer financial protection realm. The remainder of the chapter focuses first on defining the objectives of consumer protection, including the dynamics of market failure in consumer financial protection. Next, it examines the institutions of consumer protection. Finally, the chapter considers the various tools that the CFPB possesses with respect to consumer financial protection and the strengths and weaknesses of those various tools.

II. Consumer Financial Protection Objectives

Consumer financial protection has two objectives. First, consumer financial protection is not an end in itself it should be recognized as one component of a larger consumer welfare analysis. Consumers benefit not only from consumer protection narrowly understood, but also from greater choice, innovation, and competition that drives higher quality and lower prices. In particular, to the extent that consumer protection efforts are inefficient and excessive, they can have the unintended

[34] *See* 12 U.S.C. §5511(c).

consequences of reducing access, deterring innovation and competition, and raising prices. But even more, poorly-tailored regulation can actually result in *greater* harm to consumers by creating market power for some providers or by driving consumers into the black market. Therefore, the scope of consumer protection must be properly defined as well as the particular harms to consumers that consumer protection law seeks to remedy, such that the benefits of consumer protection interventions actually aid consumers and make them better off.

A. Consumer Financial Protection Goals

As noted by the NCCF and as codified in Dodd-Frank, sound consumer financial policy should be organized around four elements: (1) competition; (2) access and inclusion; (3) provision of information to consumers to help them make reasonably informed decisions and promote competition in the marketplace; and (4) "elimination of market excesses," the traditional realm of consumer protection. Elements (1)-(3) are the subject of upcoming chapters in this Report; this chapter focuses on the final element, "elimination of market excesses" which can be understood as protecting consumers from harm from fraudulent and oppressive practices.

Consumers benefit from both heightened consumer protections but also benefits of greater competition: lower prices, higher quality, and greater innovation. Efficient consumer protection rules, as described below, need not necessarily entail a tradeoff between consumer protection goals on one hand and competition on the other. But at least in some cases, consumer protection law can raise costs and create barriers to entry to new competition. In carrying out their mission, therefore, consumer protection regulators should take care to avoid making their regulations broader or vaguer than necessary to protect consumers if doing so will also reduce consumer welfare by unduly restricting competition or increasing costs.[35] This concern about the optimal specificity of regulation is analogous to the well-known tradeoff in antitrust law between Type-I and Type-II errors, namely the difficulty of protecting the public from anticompetitive behavior while also being careful not to prohibit pro-competitive behavior.[36] Although broad and vague rules provide regulators with more flexibility to prevent harm to consumers, doing so provides incentives for providers of financial products to eschew offering new products or serving potential customers that could bring with them heightened risk of regulatory action.

Consumer welfare is maximized when informed consumers can find the financial products and services they need in a competitive marketplace. Under these circumstances, voluntary transactions are beneficial to consumers, providers of financial services, and the national economy. In addition, a well-functioning consumer financial system is crucial to the overall national economy; approximately 70 percent of American economic activity is related to consumer spending and much of that economic activity is enabled by financial access to bank accounts, credit cards, and other consumer financial products. As painfully learned during the 2008 financial crisis and subsequent Great Recession, a breakdown in the consumer financial system can have dramatic adverse effects on the overall economy. By equal measure, the resilience of the nation's retail economy in response to the coronavirus pandemic in 2020 was possible only because of the ability of the free market to adapt to a rapid transition to online and non-face-to-face transactions and the rapid abandonment of cash transactions Fraudulent, deceptive, and

[35] *See* Zywicki, *Savior or Menace?*, supra note 31.
[36] *See* Christopher Mufarrige and Todd Zywicki, *The Limits of Consumer Protection* (working paper, Sept. 2020); *see also* Frank Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984).

unfair practices interfere with this benevolent process, however, by enabling fraudulent providers to lure consumers into transactions that leave them worse off and enable crooked providers to lure business away from legitimate competitors. Rules that prohibit fraud, deception, and unfair practices, therefore, improve market efficiency, consumer welfare, and the competitive process.[37] Moreover, absent assurances that they will not be taken advantage of by overreaching financial services providers, consumers will be reluctant to use financial products, thereby foregoing the benefits from doing so.

This dynamic can be illustrated by the example of debt collection practices and their regulation, which also happened to be a primary concern of the NCCF with respect to consumer protection.[38] The economics of debt collection and creditors' remedies is straightforward.[39] With respect to the supply of credit, creditors will be less willing to lend if they are unable to reliably collect their debts and will charge higher prices in expectation of higher loss rates (which, in turn, will lead to less lending and still higher prices).[40] Allowing legal recourse, but imposing various limits on specific debt collection practices will not deter lending completely but will raise the risk and loss rates from lending. In turn, higher risk and loss rates will raise costs, forcing lenders to raise their prices to offset those losses (such as by raising interest rates, requiring downpayments, or other term repricing behavior). Restrictions on useful creditors remedies, therefore, will

[37] Brian Johnson, Acting Deputy Director, Consumer Financial Protection Bureau, "Toward a 21st Century Approach to Consumer Protection," Remarks to Consumer Action (Nov. 15, 2018), available in [HYPERLINK "https://www.consumerfinance.gov/about-us/newsroom/toward-21st-century-approach-consumer-protection/"].

[38] *See* NCCF Report, *supra* note [NOTEREF _Ref54725517 \h], at Chapter 3.

[39] *See* Todd J. Zywicki, *The Law and Economics of Debt Collection and Its Regulation*, 28 LOYOLA CONSUMER L. J. 167 (2016).

[40] *Id.* Note that legal recourse is not the only way in which creditors collect debts. Consumers voluntarily repay debts in order to preserve access to credit in the future or to avoid adverse consequences for their reputation as transmitted through their credit rating. Legal recourse, therefore, is one additional mechanism at the margin that can be relied on to collect debts. For simplification we focus on legal recourse here. *See* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J. OF L. ECON. & ORG. 5 (1985).

have an overall effect of increasing the price and reducing the quantity supplied of credit for all consumers but especially higher-risk borrowers.

The demand side, however, will exhibit the opposite dynamics. In deciding whether to borrow, consumers will consider the total costs of the loan, including not just the nominal price of the loan (such as the interest rate) but also the expected cost of potential default. Harsher and more immediate remedies will be more costly to some consumers than others, but will be especially relevant to those who are most likely to default. Limiting remedies, therefore, will increase the quantity demanded of consumer credit, as consumers will be more willing to borrow and take on credit where the consequences of delinquency and default are less costly.[41]

A restriction on creditors' remedies, therefore, will have two simultaneous and offsetting impacts: it will simultaneously reduce the quantity supplied of credit and increase the quantity demanded.[42] Thus, the end result will unambiguously be a higher equilibrium price for credit, but the equilibrium quantity of credit could be either lower *or* higher, depending on how lenders and borrowers adjust to the new mix of prices and remedies. The point can be illustrated in Figure 6-1:

[41] Note that the economics of interest rate controls are identical—lenders will reduce the quantity supplied of loans and consumers will increase their demand for credit at the controlled price.
[42] Zywicki, *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h].

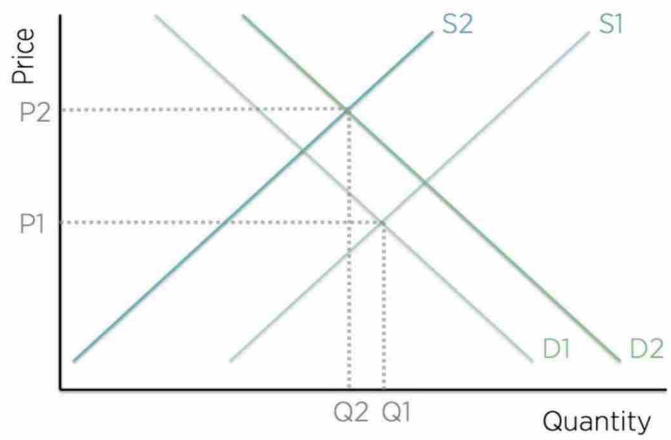

Figure 6-1 illustrates an inefficient restriction on creditors' remedies that reduces the equilibrium quantity of credit. Although consumer demand shifts out from D1 to D2, the supply shift from S1 to S2. In other words, the hypothetical restriction illustrated in Figure 6-1 is harmful to consumers in that the reduced supply (and increased price) that results from the new restriction exceeds the value that consumers place on it.

If Q2 were to right of Q1, meaning that equilibrium quantity of credit increased, then the hypothetical restriction would be welfare-enhancing. That result would indicate that the consumer places a higher monetary value on the elimination of that potential remedy than the increased cost necessary to obtain it and consumer welfare would be improved overall. Notably, this result suggests that there is no reason to believe that there is an inherent conflict of interest or zero-sum relationship between consumers and providers of financial products. Sound and efficient consumer credit regulation should be viewed as positive sum in nature, as by increasing consumer confidence it will increase consumer demand for those products and services, thereby benefiting consumers, providers, and the economy overall.[43]

Empirical studies of the effects of restrictions on creditors' remedies that followed the NCCF Report and the Fair Debt Collection Practices Act suggested that many of those rules might have reasonably been concluded to be economically efficient in that they eliminated practices that were of minimal value to financial services providers but were strongly disliked by consumers. Indeed, as discussed below, many of the creditors' remedies that were barred already were little-used by most creditors for precisely this reason.

Regulation will have distributional effects in addition to efficiency effects. Interest-rate ceilings on consumer financial products traditionally have been justified as beneficial for low-income consumers. As is the case with the effect of usury laws, inefficient restrictions on creditors' remedies will also end up hurting higher-risk consumers more than lower-risk consumers.[44] Inefficient regulations increase the costs of collections by reducing the efficacy of collection measures, thereby increasing losses and reducing the returns per dollar invested in collections. As a result, restrictions on creditors' remedies will increase the risk and cost of lending to all potential borrowers but will increase the risk of lending to higher-risk consumers most. *Ex post*, riskier consumers would benefit most from strict restrictions on collection activities as they are most likely to default and be subjected to collection efforts. But *ex ante*, these same

[43] *See* Todd J. Zywicki, *The CFPB Could Be a Force for Good*, WALL ST. J. (Feb. 19, 2018). Similarly, although consumers are liable for the first $50 of losses associated with credit card fraud, virtually all credit card issuers waive that obligation and fully reimburse the consumer, in order to provide the consumer with confidence to use the card free from that risk.

[44] *See* Zywicki, *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h].

consumers are those who are most likely to be harmed from excessively strict limits on creditors' remedies once offsetting adjustments by creditors are taken into account. Regulatory limits will lead to compensating adjustments by lenders to reduce losses, most notably leading to higher lending underwriting standards and rationing lending to riskier consumers (as well as reducing available credit lines to most consumers), but also higher interest rates, requiring larger downpayments, and shorter maturities (resulting in higher monthly payment obligations).[45] Lower-income consumers will have greater difficulty coming up with liquid funds for a larger downpayment or meeting higher monthly payment obligations than will higher-income consumers.[46] In addition, there are many costs associated with collecting debts that do not scale one-to-one with the size of the loan; as a result, smaller loans are more expensive to collect per dollar loaned than larger loans.[47] As a result, lenders will also raise their minimum loan size to an amount that is economically feasible to collect.[48] Higher minimum loan size will exclude low-income and higher-risk borrowers that could have qualified for a smaller loan but are unable to be underwritten at a larger loan size. Overall, therefore, although economically inefficient restrictions on creditors' remedies benefit those borrowers who do not pay their

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[45] *See* Douglas F. Greer, *Creditors Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections*, *in* 5 TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 154 (1973); James A. Barth, et al., *The Effect of Government Regulation of Personal Loan Markets: A Tobit Estimation of a Macroeconomic Model*, 38 J. FIN. 1233 (Sept. 1983); James R. Barth, Joseph J. Cordes, & Anthony M. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J. L. & ECON. 357 (1986); William C. Dunkeberg, *Banks Lending Response to Restricted Creditor Remedies* (Credit Research Ctr. Working Paper No. 20, 1978); Viktar Fedaseyeu, *Debt Collection Agencies and the Supply of Consumer Credit*, FED. RES. BANK OF PHILADELPHIA RESEARCH DEPARTMENT WORKING PAPER WP 20-06 (Feb. 2020).

[46] Higher-income consumers are also more likely to have access to assets that can provide collateral for a loan, such as home equity lines of credit. *See* Zywicki, *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h]; *see also* Richard M. Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168 (2002).

[47] For example, the cost of making a phone call or sending a collections letter is largely the same regardless of the size of the obligation being collected, thus there is some minimum loan value amount below which it would not be economical to collect in the event of default.

[48] *See* Dunkelberg, *supra* note [NOTEREF _Ref54726434 \h], at 9.

obligations, those benefits are funded largely by other higher-risk consumers who pay higher interest rates and gain less access to credit.[49]

[redacted]

Much of modern debate over the scope and substance of consumer financial regulation rests on an implicit assumption that consumer financial regulation must be zero-sum in nature, i.e., that regulation rests on a zero-sum single dimension continuum of conflict between "consumers" and "industry" and that any reduction in the cost of consumer financial regulation (i.e., "deregulation") must be "good" for industry and "bad" for consumers, and vice-versa. The Taskforce rejects this zero-sum conception as a useful way to think about consumer protection law. Instead, the Taskforce recognizes the crucial role played by well-designed consumer protection rules, regulations, and enforcement, not only in protecting consumers from fraud and other oppressive practices, but also in protecting upstanding businesses from market distortions caused by fraudulent businesses and the adverse effects on consumer confidence that those practices can cause. As a result, the Taskforce expressly rejects the construct of "deregulation" versus "more regulation" as useful and instead believes that the overall objective of consumer financial protection policy should be to adopt rules, regulations, and practices that improve consumer welfare and promote fair and transparent markets and the elimination of practices that interfere with that goal. Rules that promote transparency and facilitate shopping, such as well-designed disclosure rules, and rules that promote fair treatment of consumers, such as well-designed limits on creditor remedies, can provide benefits to consumers, providers, and the overall economy.

B. The Role of Consumer Financial Protection Regulatory Agencies

[49] *See* Zywicki, *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h].

The institutional framework of consumer protection, including consumer financial protection, has been described through the analogy of a "three-legged stool."[50] As then-Acting CFPB Deputy Director Brian Johnson explained the three-legged stool idea in a speech in November 2018:

> The first leg is competition through the marketplace. The second is the framework of contract rights, property rights, and related legal obligations executed and enforced through the legal system. The third leg is public agencies. When competition and contract rights cannot adequately restrain market participants who don't play by the rules, public agencies must help bear the weight of policing the markets.[51]

Each of the three legs of the stool reinforce each other and make the system more stable, "Just as a two-legged stool is unstable, markets and private legal rights, while indispensable to the American economy, falter unless buttressed by a third leg."[52] The third leg of the stool in the United States is public agencies, which can help the other legs work better, such as by creating a framework that enables market competition to work better.[53]

1. Competition

The first leg of the stool is competition and the market process. It is recognized that competition brings about lower prices and greater variety for consumers. Often overlooked, however, is that competition also promotes consumer protection goals. By giving consumers a variety of providers of financial products and services in the market, dissatisfied consumers can walk away from low-quality or underperforming companies.

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[50] *See* Johnson, *supra* note [NOTEREF _Ref54726532 \h]; *see also* J. Howard Beales III & Timothy J. Muris, *FTC Consumer Protection at 100: 1970s Redux or Protecting Markets to Protect Consumers?*, 83 GEORGE WASHINGTON L. REV. 2157 (2015). The three-legged stool analogy is adapted from Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. OF L. & POL. 393, 400 (2001).
[51] Johnson, *supra* note [NOTEREF _Ref54726532 \h].
[52] Beales & Muris, *supra* note [NOTEREF _Ref54726563 \h], at 2163.
[53] As discussed below, we include within this third leg of the stool the value of competitive federalism and experimentation among different state regulatory systems.

This threat of punishment for businesses that do not satisfy their customers can provide a powerful check on opportunism and low quality.[54] Often, the economic fallout from a scandal or reports of consumer mistreatment will far exceed the costs to the company from any direct regulatory costs or fines.[55] Jobs are frequently lost, including those of senior management. In addition, trusted third party evaluators, such as Consumer Reports or JD Power, provide valuable information about various providers of services.

Advertising also provides information about new products and services as well as comparative information about rival sellers.[56] For example, some commenters have expressed concern about so-called "hidden" or "shrouded" fees on consumer products and services and point to the various fees assessed by airlines as supposed examples of the phenomenon. But the authors provide no evidence that consumers are unaware of schedule change fees, bag fees, or other similar fees, and it seems highly unlikely that after many years dealing with such fees more than a tiny fraction of consumers would be unaware of these fees. More important for current purposes, however, is that Southwest Airlines has made its tag line "Bags Fly Free" and other elements of price transparency a defining characteristic of its customer brand, along with eschewing other similar fees, such as schedule change fees and the like. According to a subsequent analysis, although Southwest's decision to forego such fees cost it an estimated $500 million per year in new revenues, the company more than offset that amount by increasing its market share

[redacted]

[54] *See* L. G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980); Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).
[55] *See* Thomas D. Dowdell, Suresh Govindaraj, and Prem C. Jain, *The Tylenol Incident, Ensuing Regulation, and Stock Prices*, 27 J. FIN. AND QUANTITATIVE ANALYSIS 283 (1992); Mark L. Mitchell and Michael T. Maloney, *Crisis in the Cockpit? The Role of Market Forces in Promoting Air Travel Safety*, 32 J. L. & ECON. 329 (1989); Mark L. Mitchell, *The Impact of External Parties on Brand-Name Capital: The 1982 Tylenol Poisonings and Subsequent Cases*, 27 ECON. INQUIRY 601 (1989).
[56] The role of advertising in the competitive process is discussed in greater detail in Chapter 7.

by two percentage points, increasing passenger loads by 10%, and $2 *billion* in incremental annual revenue.[57]

The importance of competition and responsiveness to consumer demand applies to the consumer financial services industry as well as other consumer markets. For example, when the CFPB asked consumers what steps they would take if they felt like they had been charged an incorrect fee, a majority said that they would cancel their credit card and change to a different issuer.[58] Survey research conducted by the Federal Reserve suggests that this threat by consumers is credible as 92 percent of consumers report that they "can easily get a credit card from another company if they are not treated well."[59]

Given this high degree of competition and ease with which consumers can abandon unsatisfactory providers it is not surprising that consumers generally express a high degree of satisfaction with their credit card providers. According to the Federal Reserve, 95 percent of consumers express that they are "generally satisfied" in their dealings with credit companies and only 5 percent express that they are dissatisfied. In addition, 93 percent of customers believe that credit card companies treat them fairly versus only 7 percent who disagree.[60]

In turn, financial service providers seek to keep their customers happy in order to preserve the benefits of the relationship as well as the company's positive reputation with customers. Acquisition of new customers is expensive, and banks will find it far less expensive in the long run to keep a loyal customer satisfied than to fight over a few

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[57] *See* Geoffrey Manne & Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, 10 J. L. ECON. & POL'Y 555 (2014).
[58] CONSUMER FINANCIAL PROTECTION BUREAU, ARBITRATION STUDY Section 3 page 3 (March 2015).
[59] Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 FED. RES. BULLETIN 1 (Issue 5, Dec. 2013); *see also* Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 FEDERAL RESERVE BULLETIN 623 (200).
[60] Canner & Elliehausen, *supra* note [NOTEREF _Ref54727366 \h].

overdraft or late fees. Thus, the first step most consumers take if they feel that they have been assessed an unfair fee is to complain to the bank and ask for a refund, with the implied threat of changing banks if they are not satisfied. This desire to retain consumers often leads the bank to ~~issue a~~ voluntarily issue~~ing~~ a refund. Examining the reports of one medium-sized regional bank, for example, Johnston and Zywicki found that overall in about 68 percent of cases in which consumers complained about a fee (such as an overdraft fee or wire transfer fee), the bank issued a complete refund.[61]

The value of treating customers fairly is illustrated by the public response to the infamous Wells Fargo "fake account" scandal that came to light in 2016.[62] A survey of consumers soon thereafter found that "positive perceptions" of the bank fell from 60% before the scandal to 24% after the scandal, while negative perceptions increased from 15% before the scandal to 52% post-scandal. In addition, 30% of Wells Fargo customers stated that they were actively exploring other alternative banks and 14% had already made the decision to switch banks as a result of the scandal. Overall, one analysis estimated that Wells Fargo would lose approximately $99 billion in deposits and $4 billion in revenue as a result of customer fallout from the scandal. Moreover, only three percent of potential new customers stated that they would be willing consider doing business with the bank. Overall, Wells Fargo lost an estimated $220 billion in market capitalization as a result of the fake account scandal and market and regulatory responses to it.[63]

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[61] *See* Jason Scott Johnston & Todd Zywicki, *The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique*, 35(5) BANKING & FIN. SERVS. POL'Y REPORT 9, 20 (May 2016).
[62] *See* cg42, *Wells Fargo Mini-Study* (Oct. 2016), *available in* [HYPERLINK "http://cg42.com/wp-content/uploads/2016/12/cg42-Wells-Fargo-Mini-Study-102016vF.pdf"].
[63] *See* Hannah Levitt, *Wells Fargo Has Lost $220 Billion in Market Value Under Fed Cap*, BLOOMBERG.COM (May 15, 2020), *available in* [HYPERLINK

Social media has increased the potential reputational harm to financial services providers from satisfied dissatisfied consumers by amplifying their experiences. Websites such as Yelp and Google enable consumers to testify directly to their experiences with various providers and products. Testimonials of actual consumer experiences ameliorate the traditional information asymmetries between consumers and providers of services, even in traditional redoubts of government regulation, such as occupational licensing. Recent research finds that consumers today place greater value on the experiences of other consumers, as measured by online reviews, than they do on traditional criteria such as government-issued licenses.[64]

Credible third-party experts also provide valuable information to consumers about goods and services that are complex or are credence or experience goods about which consumers cannot verify ~~their~~ quality until they actually use those products and sometimes even after they use the product. Organizations such as JD Power and *Consumers Report* provide information on a variety of goods and services, including bank accounts, credit cards, mutual funds, and other financial products and services. In recent years this traditional mix has been supplemented by a variety of other expert sites that will assess and grade financial products, such as WalletHub.com and Nerdwallet.com. Purported market "failures," therefore, ~~lead~~ can produce responsive market "solutions" as a result of consumer demand and the competitive process. Information about those products and services is useful to consumers and creates a profit

"https://www.bloomberg.com/news/articles/2020-05-15/wells-fargo-has-lost-220-billion-in-market-value-under-fed-cap"].

[64] *See* Chiara Farronato, Andrey Fradkin, Bradley Larsen, & Erik Brynjolfsson, *Consumer Protection in an Online World: An Analysis of Occupational Licensing*, NBER working paper w26601 (Jan. 2020).

opportunity for those who can help deliver reliable, user-friendly information to consumers.

On the other hand, despite these many and varied ways that markets provide assurance to consumers about the quality of the good, services, and providers that they consume and with whom they interact, there may nevertheless be residual market failures from information asymmetries, “externalities,” or market power that markets are unable to correct for themselves because of high transaction costs or poorly-specified property rights.

2. Common Law

Common law rights and remedies—namely contracts, property, and tort—provide the second leg of the stool by providing a mechanism for consumers to vindicate their rights in situations in which sellers defraud or harm consumers. Legal enforcement of contract terms and protection against fraudulent practices supplement the competitive process in providing consumer protection to consumers and making markets work more effectively.

Market forces, particularly the desire to retain repeat customers and to prevent adverse reputational consequences provide a powerful motive for keeping one’s promises and eschewing fraud. But there are limits to this incentive for self-enforcing promises. For example, a seller might believe that there is a low likelihood that a consumer might detect the improper behavior and thereby punish the miscreant business. Or the seller might face attenuated competitive constraints, such as market power, that enable them to cheat consumers with minimal fear of punishment. Or the seller might simply believe that the short-term benefit of cheating a consumer or group of consumers exceeds any damage to the business's reputation at large. Regardless of the possible source of market failure, legally enforceable private rights of action for fraud, warranty, and the like, provide a vehicle for wronged consumers to vindicate their rights and gain recompense from seller misbehavior.

But reliance on common law rights and private lawsuits to protect consumers is imperfect as well. In the first instance, vindication of common law rights places the burden on individual consumers to bring a legal action and some consumers might be unwilling or unable to do so. Wronged consumers might be reluctant to initiate a lawsuit because of the legal fees involved or because of the stress of initiating litigation. Consumers might also have limited incentive to initiate a lawsuit, particularly where the loss to any individual consumers is small relative to the cost of litigation. Arbitration and other types of alternative dispute resolution reduce the costs of conflict resolution and thereby ~~to~~ enable consumers to better vindicate their rights without requiring a lawyer and extensive litigation. Arbitration tends to be relatively informal and often does not require a lawyer. Lawsuits, by contrast, are highly formal and failure to use a lawyer risks running afoul of the various rules and complexities of court proceedings, resulting in the dismissal of one's case.

Cases in which the harm to any individual consumer is small or difficult to detect are particularly problematic. The low probability of detection might render market protections somewhat ineffective. And the small amount of harm to each consumer might undermine their incentive to sue. But from the perspective of a fraudulent seller, these types of harms might be particularly lucrative, as the large number of consumers adversely affected provides an opportunity to collect large sums of ill-gotten gains.

In theory, class action lawsuits provide a mechanism for pooling together many small claims of wrongdoing and thereby creating an incentive to sue. But class action proceedings are riven with their own problems for consumers, most notably that the small stakes involved in any given case for an individual plaintiff tempers the incentive for any one of them to monitor the actions of their lawyers closely.[65] This can produce class actions settlements that are far more beneficial for class counsel than for class members, as class members might receive nominal redress while their lawyers receive substantial legal fees. And while in theory the initiation of a class action proceeding might provide an individual plaintiff with his or her "day in court" before a judge, in practice the number of class action cases litigated is vanishingly small. Instead, class action cases are invariably settled or dismissed prior to reaching trial, depending on whether the class is certified or not.

[redacted]

Moreover, as Jason Johnston has observed, some class action cases are essentially "no harm" cases in that the class action is brought despite a finding of no tangible harm to any consumer.[66] These "no harm" cases produce no benefit to consumers because of the absence of any harm, yet they impose a cost on the company that must eventually be passed on to other customers. Often these cases involve claims to vindicate laws that provide for a minimum size of "statutory damages" for a violation, such as $500 or $1000 per violation, without requiring showing of actual harm to the consumer. Ironically,

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[65] *See* Jason School Johnston and Todd J. Zywicki, *The CFPB's Arbitration Study: A Summary and Critique*, 35(5) BANKING AND FIN. SERVS. POL'Y REPORT 9 (2016).
[66] *See* Jason Scott Johnston, *High Cost, Little Compensation, No Harm To Deter: New Evidence on Class Actions Under Federal Consumer Protection Statutes*, 2017 COLUM. BUS. L. REV. 1 (2017).

statutory damages were often provided in the first place in order to provide adequate economic incentives for individual plaintiffs to sue in response to alleged violations by providing sufficient damages to make such a suit economically worthwhile. When combined with the class action process, however, the presence of statutory damages can dramatically increase the damages for a violation that far exceeds any actual harm to consumers from the violation.[67]

Common law rights, therefore, can supplement market mechanisms in situations in which consumer harm occurs notwithstanding the incentives not to cheat. Yet even though common law rights and remedies are a powerful supplement to market mechanisms, they too can solve some problems but retain problems of their own. The primary responsibility for vindicating common law rights rests on the individual consumer, which can result in inadequate incentives for consumers to do so. This can especially be a problem when harm to any individual consumer is small but many consumers are harmed.

3. Regulatory Agencies

The third leg of the consumer protection stool is public agencies at the state and federal level. As with the other two legs, the leg of public regulatory agencies is to stabilize the stool by reinforcing the other two legs of the stool. Making this third leg too large relative to the other legs or placing it in too central of a position in the system will make the stool less steady and unbalanced. Moreover, not only is it essential to understand the relative position of public agencies in supporting the overall structure of

[67] It is unclear to what extent the Supreme Court's decision in *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540 (2016), might mitigate this problem with statutory damages. Lower court applications of *Spokeo* to various statutes and fact situations remain unsettled. *See, e.g.*, *Trichell v. Midland Credit Management*, 954 F.3d 990 (11th Cir. 2020) (holding that plaintiff lacked standing to sue under the Fair Debt Collection Practices Act where he could show no "concrete injury" from misleading communication).

consumer protection, there is the additional question as to *which* level of government, state or federal, is the best one to deal with any particular consumer harm.

Properly designed and executed, public agencies can help markets ~~to~~ work better for consumers and address market failures when market and common law responses are insufficient to maximize consumer welfare. By preventing fraud and other harms to consumers, public agencies can help ensure that the competitive process is fair and efficient for consumers.[68]

In most instances, public agencies should be seen as a last resort, rather than first resort, for dealing with potential market failure. Regulation and public enforcement actions are blunt instruments for dealing with potential consumer harms and run the risk of unintended consequences. Market processes are grounded in the concrete choices of individual consumers and individual financial services providers, thus those processes can provide highly nuanced and personalized product and service attributes to individuals or small groups of consumers. Similarly, common law rests on actual harms that arise from particular consumers' interactions with providers. Public agency action, by contrast, is concerned with larger more abstract groups of consumers and providers. This has certain efficiencies associated with it, but in providing recourse or harm-prevention to large categories of consumers, public agency action sacrifices the individualized nature of market and common law decision-making. Moreover, by creating highly generalized rules that eventually will apply to particular persons in particular contexts, agency action will produce unintended consequences where the rule or enforcement action fits imperfectly with the needs and preferences of particular consumers and providers.

[68] *See* discussion in Chapter 8.

In contrast to private ordering through market transactions and voluntary contracts, agency action can be understood a type of central planning, where the agency creates general rules that apply to categories of transactions. As a result, just as markets and common law "fail" in certain predictable contexts, government agencies (and legislatures) predictably "fail" as well.[69] Two factors stand out: (1) the knowledge problem and (2) the problem of incentives.

First, agencies, like other central planners, suffer from the knowledge problem associated with central planners seeking to collect and synthesize information that is then transmitted as data into decisions by consumers and businesses.[70] Although agencies can collect data and other types of evidence, this information is not the same as the knowledge of "time and place" that arises from particular individuals making particular decisions in particular contexts under particular constraints.[71] For example, most auto title pawn customers are consumers. Yet research indicates that some ~~of~~ customers who appear to be ordinary individuals are actually small, independent businesspeople who use their vehicle (van or pickup truck, for example) as a source of short-term business finance.[72]

For example, a landscaper might pledge his truck on Monday to gain access to cash to buy mulch, sod, bushes, and labor, then perform yardwork the next two days and be paid at the end of the week at which he will redeem the vehicle loan. A handyman or painter might similarly pledge his or her vehicle to access short-term cash to purchase

[69] *See* MAXWELL STEARNS, TODD J. ZYWICKI, AND THOMAS MICELLI, LAW AND ECONOMICS: PRIVATE AND PUBLIC 798-806 (discussing characteristics of agency decision-making).
[70] *See* Christopher Mufarrige and Todd J. Zywicki, *Simple Rules for a Complex Regulatory World: The Case of Financial Regulation*, __ EUROPEAN J. OF L. & ECON. __ (Forthcoming 2021).
[71] *See* F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).
[72] *See* Todd J. Zywicki, *Consumer Use and Government Regulation of Title Pledge Lending*, 22 LOYOLA CONSUMER L. REV. 425 (2010); Jim Hawkins, *Credit on Wheels: The Law and Business of Auto-Title Lending*, 69 WASH. & LEE L. REV. 535 (2012).

supplies that is repaid just a few days later on completion of the job. As a result, a particular individual might access multiple loans over a several month period, but each one is repaid quickly, with a high degree of certainty, and with minimal interest charges. To the regulator, however, this individual might appear to be a one-size-fits-all individual caught in a so-called "debt trap" who borrows repeatedly. The lender and customer, by contrast, are more likely to know the real purpose of the transactions and whether they are problematic. Selecting an arbitrary variable, such as the number of loans that a borrower is permitted to use, can also produce harmful adjustments and offsetting behavior by borrowers, such as keeping an auto title loan outstanding for a longer period of time, or borrowing a larger amount of money than needed as a hedge against future needs, that could produce more finance charges than would otherwise occur.

Another example is that of consumer usage of overdraft protection.[73] When queried in the abstract about whether they would want the ability to be able to use overdraft protection on their debit card, a large minority of consumers say no. But when asked if they would like to have access to overdraft protection *in emergency situations*, a large majority of consumers say that they would, indicating that they plainly had not thought of that scenario under the generic phrasing of the question and then changed their mind when that situation was presented to them.[74] In short, consumers themselves may not always know the choices that they would make in particular contexts until they are actually confronted with those choices.[75] Moreover, when confronted with the exact same

[73] *See* Adam C. Smith and Todd Zywicki, *Behavior, Paternalism, and Policy: Evaluating Consumer Financial Protection*, 9 NYU J. L. & LIBERTY 201 (2015).
[74] *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, DESIGN AND TESTING OF OVERDRAFT DISCLOSURES: PHASE TWO 18-19 (Oct. 12, 2009).
[75] THOMAS SOWELL, KNOWLEDGE AND DECISIONS 218 (1980) ("The real problem is that the knowledge needed is a knowledge of *subjective patterns of trade-off that are nowhere articulated*, not even to the individual himself. I might *think* that, if faced with the stark prospect of bankruptcy, I would rather sell my

choice in the exact same situation, different individuals might make different choices. For example, depending on their situation and personal preferences, one person might be willing to borrow money to buy a minivan when he has children while someone else might not be willing to do so until he saved up enough to purchase it with cash. In short, the economic value that people place on various consumption goods and the use of credit to purchase them is "subjective"—not only do different people choose differently from one another, the *same* person might make different choices in different contexts or at different times.[76] Unless it is done carefully, government regulation intended to help can actually harm many consumers if it fails to take account of these subjective preferences that people hold and the different contexts in which they find themselves.

A second danger with agency action and government regulation is the problem of incentives, both from external interest-group pressures as well as the agency's internal dynamics.[77] The danger is most obvious in the context of consumer protection enforcement activity under state law where the attorney general is an elected official. In carrying out their enforcement activities, elected AGs invariably will have at least one eye focused on the political elements and consequences of their actions, both for the electorate at large but also for important interest groups that disproportionately influence the AGs political fate either for re-election or for promotion to higher office.[78] In

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automobile than my furniture, or sacrifice the refrigerator rather than the stove, but unless and until such a moment comes I will never *know* even my own trade-offs, much less anybody else's.").

[76] Todd J. Zywicki, *A Unanimity-Reinforcing Model of Efficiency in the Common Law: An Institutional Comparison of Common Law and Legislative Solutions to Large-Number Externality Problems*, 46 CASE WESTERN L. REV. 961 (1996) (discussing subjective value); JAMES M. BUCHANAN, COST AND CHOICE: AN INQUIRY IN ECONOMIC THEORY (1969).

[77] *See* JAMES M. BUCHANAN AND GORDON TULLOCK, THE CALCULUS OF CONSENT 204-212 (1999) (originally published 1962); MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

[78] *See* Colin Provost, *The Politics of Consumer Protection: Explaining State Attorney General Participation in Multi-State Lawsuits*, 59 POLITICAL RESEARCH QUARTERLY 609 (2006).

addition, the attorney general will also have her own personal policy agenda that she desires to promote while in office.[79] How these various and competing influences of the public, interest groups, and their own personal agendas, will play out in practice is difficult to predict. What is not difficult to predict, however, is that the agency's consumer protection agenda will be influenced by political considerations as well as what factors constitute optimal policy for consumers.[80]

Federal agencies face different external and internal political influences from state attorneys general. Executive agencies technically report to the President, who is democratically accountable to the electorate. Although politics and special-interest influence is attenuated in this process, there is little doubt that political calculations enter into the agenda of executive agencies through Presidential appointments and control. Congress also provides political influence over Executive agencies through its oversight and budgetary control. Independent agencies are somewhat more independent of Presidential control. Yet this does not mean that they are immune to political influences. Research suggests that independent agencies are substantially influenced by Congress through a variety of formal and informal means.[81]

But eliminating external democratic oversight does not eliminate the influence of politics and ideology. Agencies are also subject to internal political pressures arising from their staff. Precisely because of the attenuated external political control over public agencies, the staff of those agencies has a greater range of discretion to influence policy

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[79] *See* Colin Provost, *An Integrated Model of U.S. State Attorney General Behavior in Multi-State Litigation*, 10 STATE POLITICS AND POLICY QUARTERLY 1 (2010).
[80] *See* Colin Provost, *When is AG Short for Aspiring Governor? Ambition and Policy Making Dynamics in the Office of State Attorney General*, 40 PUBLIUS: THE JOURNAL OF FEDERALISM 597 (2010).
[81] *See* Barry R. Weingast and Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765 (1983).

and to advance their own ideological and personal goals. In some instances, this discretion permits agency employees to aggressively expand the agency's reach to regulate behavior beyond that which is reasonably in its scope.[82] To some extent, this imperialistic drive arises from the natural self-interest of agency personnel to advance their own careers and to expand the power, prestige, and budget of the agency.[83] In addition, staff employees have their own ideological and political views that can dramatically influence the agency's direction and temper efforts to redirect the agency's mission in accordance with either the President's or Congress's vision.[84] Professor Roberta Romano has argued that the CFPB's lack of democratic oversight has also led it to favor less transparent and less publicly accountable mechanisms for policy making.[85] Moreover, those who head agencies might have future elective or appointive political ambitions themselves, which could influence their decision-making while running the agency.[86] In general, the greater is the independence and insulation of agencies from oversight and control by democratically-elected officials the greater will be the opportunities for those within the agency to shape it according to their own goals and vision rather than those of the democratically-accountable branches.[87]

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[82] *See* STEARNS, ZYWICKI, & MICELLI, *supra* note [NOTEREF _Ref54727558 \h], at 781-98 (2018).
[83] *See* WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT (1971).
[84] *See* Timothy J. Muris, *Regulatory Policymaking at the Federal Trade Commission: The Extent of Congressional Control*, 94 J. POL. ECON. 884 (1986); Zywicki, *Savior*, *supra* note [NOTEREF _Ref54727638 \h].
[85] *See* Roberta Romano, *Does Agency Structure Affect Agency Decisionmaking: Implications of the CFPB's Design for Administrative Guidance*, 36 YALE J. ON REG. 273 (2019).
[86] Zywicki, *Savior*, *supra* note [NOTEREF _Ref54727638 \h].
[87] This is a phenomenon known as "agency drift" as the agency's actions "drift" from the policy preferences of the enacting Congress. *See* David Epstein and Sharyn O'Halloran, *Administrrative Procedures, Information, and Agency Discretion*, 38 AM. J. POL. SCI. 697 (1994).

Overall, the lesson is crucial to remember—just as "market failure" predictably can occur, so can "political failure."[88] As a result, just as markets and common law are imperfect institutions, legislative and regulatory bodies are imperfect as well. In determining the optimal allocation of authority among various institutions it is important to avoid the "Nirvanna Fallacy," i.e., the assumption that just because one institution is imperfect that some other institution must function better.[89] How regulatory agencies can assess the wisdom and efficacy of interventions is discussed below.

C. Special Cases of Market Failure

Economists have identified several general situations in which market failure may occur, such as asymmetric information, externalities, and market power (i.e., monopoly power) by sellers. In addition, there is another discrete category of consumer interactions that plainly have the potential to produce market failure for consumers: namely, those in which the consumers are affected by a firm's behavior, yet consumers lack the opportunity or authority to choose the firm that provides the services. Although there are clear economic justifications for why these industries are structured as they are, they can nevertheless lead to potential problems for consumers since those firms are paid by and owe their allegiance to some other party.

Examples of service providers that provide consumer services but which the consumer lacks the authority to control, hire, and fire, include those such as debt collectors, credit reporting agencies, and mortgage servicers. Not coincidentally, the consumer reporting industry and debt collection industry are the top two sources of

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[88] James M. Buchanan, *Market Failure and Political Failure*, 8(1) CATO J. 1 (1988).
[89] Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J. L. & ECON. 1, 1 (1969) ("In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.").

consumer complaints in the CFPB's Consumer Complaint database and mortgage complaints rank fourth.[90]

The rationale for this market arrangement with respect to these providers is clear, notwithstanding their potential for consumer harm. Consider the debt collection industry. As discussed above, fair and reliable collection of consumer debts is essential for a well-functioning consumer economy. If creditors are unable to collect debts at reasonable cost and with reasonable certainty, then they will be less likely to lend in the first place, especially to riskier borrowers. On the other hand, if creditors can invoke tactics that are perceived as excessive and unfair by consumers, then consumers will be less likely to borrow in the first place. This leads to the implication of an optimal level of debt collection efforts that will enable creditors to collect debts efficiently while protecting consumers from overreaching practices that make them worse off

Empowering delinquent consumers to choose their own debt collectors would be unlikely to produce an optimal level of vigilance in debt collection activities. Although consumers as a whole, including future borrowers, would benefit from striking the right balance, delinquent debtors invariably would favor debt collection efforts that were too generous. This would enable those consumers to avoid repaying their obligations, losses that would be passed on to other consumers in higher prices and reduced supply of credit, especially to higher-risk borrowers. On the other hand, when the choice is left up to the creditor without the consent of the borrower, there is a fear that the creditor's collection efforts might be excessively aggressive toward the borrower.

[90] All together those three industries comprised 73 percent of all the complaints in the CFPB's database in 2019. *See* CONSUMER FINANCIAL PROTECTION BUREAU, CONSUMER RESPONSE ANNUAL REPORT, JANUARY 1-DECEMBER 31, 2019, at 9, Fig. 2 (March 2020).

But while this symmetrical conclusion intuitively suggests the presence of a market failure, it is incomplete. Although third-party debt collectors potentially might be over-aggressive in their collection efforts in some cases, a creditor that collects its own debt might be insufficiently aggressive from an economic perspective. In particular, where the debtor stands in a repeat-dealing relationship with the creditor, it is not necessarily the case that collection efforts might be too aggressive. In fact, they might actually be somewhat less-aggressive than optimal. That would be the case, for example, if the lender is a retailer extending credit to an existing customer. The retailer would obviously be concerned about collecting past due debt. But the retailer would balance this concern of minimizing losses on past due accounts, which would support aggressive collection measures, against a countervailing pressure to retain the customer for future shopping purchases. In the latter instance, the retailer might be more passive in collecting past due debt than otherwise would be economically efficient, with some of those losses being passed on to other consumers.[91] And, consistent with that idea, data collected by the NCCF suggested that retailers carried unpaid customer balances longer than other creditors such as banks and finance companies.[92] This does not necessarily demonstrate that other creditors were pursuing efficient debt-collection strategies and retailers were not, but it demonstrates the importance of repeat-dealing in shaping behavior regarding debt collection.

Third-party credit cards, such as bank-issued cards under the Visa or MasterCard logo or American Express or Discover, address part of this problem by enabling retailers to outsource the task of becoming creditors in the first place. Retailers can thereby

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[91] *See* Zywicki, *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h].
[92] *Id.*

concentrate on selling goods to consumers, which is their area of expertise, and can outsource the cost and risk of running credit operations and the unpleasantness of trying to collect delinquent debt from an otherwise good customer. Third-party debt collectors help to address this incentive problem with respect to optimal levels of collection efforts as well. By outsourcing debt collection to third parties, the original issuers of the debt can effectively collect the debt while insulating themselves from some of the repeat-dealing and reputational consequences associated with carrying out the combative process of debt collection.[93] Third party collectors can thus be expected to be more aggressive than originating creditors in collecting debts, which will which will reduce losses and increase recoveries.

But lenders are not likely to escape adverse reputational consequences completely. Few borrowers are likely to know the identity of agency trying to collect past-due accounts (and would have no reason to pay attention for future reference) but most are likely to know the identify of the issuing entity and can be expected to hold the behavior of the debt-collection agency against the originator. This means that indirectly the originator of the debt does stand in an ongoing or repeat-dealing relationship with the consumer. Therefore, even though consumers may have limited power to punish the collection agency directly, they can still do so indirectly through their dealings with the originating creditor. As a result, even though the consumer has little power directly against the collection agency, the originating creditor does and would be likely to insist on some appropriate standards of behavior from the collection agency and limits on their activities.

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[93] Zywicki, *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h].

Moreover, default and many collections terms are set in the original contract between the consumer and originating creditor and are binding on the collections firm. As noted, this means that creditors will tend to restrain their demands for certain remedies and collection methods in order not to deter consumer demand for their product. In fact, studies conducted by the NCCF found that even though at that point collection terms in consumer contracts were lightly regulated by law (and thus largely subject to contract), creditors did not insist on dragnet-style remedies clauses that reserved every possible remedy available to the creditor at law. Instead, consumer contracts typically preserved only some of the remedies permitted by law. In general, the remedies that creditors preserved w~~h~~ere those that were seen as both most effective by creditors at collecting the debt and also most fair by consumers. Moreover, creditors actually invoked only a subset of those remedies in practice. In short, creditors tended to rely on those remedies that had the highest marginal benefit at the lowest marginal cost but which also were seen by borrowers as legitimate and fair. In addition, common law remedies for fraud and breach of contract ~~and~~ also help to police improper behavior.

On the other hand, some creditors did insist on access to all remedies upon default and might have actually pursued those in practice. A primary focus of the laws and regulations enacted at the state and federal level during that period was to standardize the industry by outlawing some of these more arcane and unexpected practices that were outliers from consumer expectations and typical industry practices.[94] By standardizing the collection terms, eliminating unusual or surprise contract terms, and preserving those that were seen as effective by creditors and fair by consumers, many of the laws and regulations at the time were arguably economically efficient.

[94] Zywicki *Debt Collection*, *supra* note [NOTEREF _Ref54726362 \h], and sources therein

Thus, even in markets ~~where markets~~that seem ineffective at protecting consumers because consumers cannot choose their provider directly, consumers may nevertheless be protected indirectly by other market forces to at least some degree. Thus, although it is often implied that non-contractual consumer markets by definition will fail to protect consumers, that assumption is not correct. To be sure, the case for government regulation and enforcement is likely to be stronger in such markets, but there are nevertheless some market forces as well as common law remedies to protect consumers. Regulation can thus play an important role in supplementing markets and common law. Other approaches could also be useful to assist creditors to monitor their agents, such as industry self-regulation and certification.[95]

Credit reporting agencies raise similar issues from a consumer protection perspective. Credit reporting agencies receive information directly from creditors without the consumer's permission. As with debt collection, if a consumer were authorized to control their information, each individual consumer would permit only positive, not derogatory information, to credit bureaus. But the selective reporting of only positive information would dramatically reduce the information content of credit bureaus. On the other hand, credit bureaus do not have an incentive to collect only negative information, because reporting both positive and negative information on consumers provides more accurate information than reporting only negative information, simultaneously producing lower delinquency rates and an expansion in the number of loans made for a given pool

[95] *See* Maureen K. Olhausen, *Remarks of FTC Commissioner Maureen K. Ohlhausen before the Direct Selling Education Foundation Self-Regulation and Consumer Protection Panel* (Apr. 7, 2015). For example, the Receivables Management Association International operates a receivables management certification program to qualified debt buyers. *See* [HYPERLINK "https://rmaintl.org/certification/"]; *see also* Reilly Dolan, *Self-Regulation and Debt Buying*, FEDERAL TRADE COMMISSION, [HYPERLINK "https://www.ftc.gov/news-events/blogs/business-blog/2015/08/self-regulation-debt-buying"] (Aug. 26, 2015).

of consumer applicants.[96] Thus, they have some incentive to provide a full and accurate picture to their customers.

But voluntary reporting by creditors can lead to errors on a consumer's file, which any particular creditor lacks the incentive to correct. This is especially problematic where the inaccuracy arises from stale information that has not been updated. Creditors have minimal incentives to update that information once the debt is either paid off or discharged. Consumers do have an incentive to monitor the accuracy of their credit reports as inaccuracies can result in paying more for credit or other harms and the credit reporting system provides processes for consumers to do that. But challenging inaccuracies in one's credit report can be time-consuming and can be aggravating and some consumers may not know how to pursue a correction, thus errors are likely to go uncorrected.

On the other hand, the credit reporting agencies have an incentive to be attentive to the accuracy of their reports in order to increase their value to creditors who purchase their services. Thus, they will not be entirely indifferent to errors in consumer reporting files. Although this to some extent aligns the incentives of the credit bureau with that of the consumer, it is an imperfect alignment. Credit reporting agencies will have an economic incentive to pursue greater accuracy only to the point at which the marginal benefit of greater accuracy with respect to aan individual consumer is equal to the marginal cost. This is unlikely to be the same point that optimizes value to the individual consumer, who internalizes all the costs (and potentially benefits) of those inaccuracies.

[96] *See* John M. Barron and Michael E. Staten, *The Value of Comprehensive Credit Reports: Lessons from the US Experience*, in CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY (Margaret Miller ed., 2003).

As a result, public agencies can play a role in crafting and implementing rules on credit rating agency practices that supplement their market incentives to pursue accuracy.

Thus, even when consumers lack direct ability to choose their provider of a service, markets, common law, and public agency regulation can still complement each other as part of a three-legged stool that can protect and empower consumers.

III. Regulation By Public Agencies

How should the CFPB think about executing its mission as part of the three-legged stool? This section discusses three elements of that question. First, it provides a framework for assessing when government intervention is appropriate. Second, it discusses contrasting approaches to regulation that have emerged, namely the difference between "market-replacing" and "market-reinforcing" regulation. Finally, this section analyzes the proper domain of consumer financial protection based on understanding consumer behavior.

A. What Is A Consumer Protection Issue?

As a threshold question, it is necessary to first understand what is a consumer protection issue? Consumer protection issues arise from contexts in which consumers make decisions that reduce their individual welfare and they are reasonably unable to avoid that result, such as decisions made as the result of deceptive or unfair practices.

This scenario can be distinguished from a different but superficially similar scenario, where consumers make decisions that are rational under the circumstances but which appear to be irrational or welfare-reducing to third parties such as government regulators. Simply because a consumer bears a cost from a decision does not mean that, on net, the consumer suffers harm from a *consumer protection* standpoint. Consumer protection harms typically flow from scenarios in which consumers do not understand the relative costs and benefits of a financial decision that they make because of fraud or some other external interference with understanding. But in some scenarios the decision by a consumer is not the result of a failure to understand the costs and benefits but instead a rational response to those incentives, which is distinct from a consumer protection harm.

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Consider the example of "rational default" on consumer loans. Multiple factors influence whether a consumer will default on an extension of credit including macroeconomic conditions that lead to default for reasons largely beyond the consumer's control, such as job loss or large unexpected expenses that create economic hardship. But in some instances a consumer defaults not because she is unable to repay the obligation but because she *chooses not* to repay. In this latter situation, the consumer's decision to default may be "rational" in the sense that, on net, the benefits of not paying the obligation exceed the costs of choosing not to pay and the consumer's default results from her response to incentives to default instead of paying the debt. Economists model the decision whether to default on a loan as an "option" contract, and it is predicted that if the costs of default increase the consumer will be more likely to default and if the costs of default decrease the consumer will be more likely to default. The concept of rational default is straightforward. Consider a consumer's decision regarding a standard 30-year mortgage.[97] Each month the consumer has a choice—she can either choose to make her monthly mortgage payment or choose not to make her monthly installment payment. The decision to make her payment in any given month is analogous to a "call" option in

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[97] *See* Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, MERCATUS CENTER WORKING PAPER No. 09-35 (Sept. 2009), *available in* [HYPERLINK "https://www.mercatus.org/publications/financial-markets/housing-market-crash"].

finance. By making her monthly payment installment, the borrower retains the option to eventually purchase the underlying asset (the home). If the consumer exercises this option for 360 consecutive months, at the end of that period she will own title to the asset free and clear. The decision to default, on the other hand, is analogous to a "put" option. The consumer can choose *not* to make the monthly payment and instead exercise her option to not buy the home and, eventually, to permit the lender to foreclose on the home and take possession and resell the collateral. The same basic model of rational default applies to any consumer loan, including credit cards, payday loans, or a payday loan.

The option theory of default suggests that consumers would be more likely to exercise their option to default when the benefits of doing so are high or the costs of doing so are low.[98] Appreciation in underlying home value increases the benefit to the homeowner of excising his call option to retain ownership of the home (or alternatively to transfer it to someone else). By contrast, declining home values make it more valuable for consumers to exercise their put option and default on the mortgage. The incentive to default will be especially powerful when the mortgage is "underwater" or in a "negative equity" position, meaning that the home is worth less than the outstanding balance on the mortgage. Under the circumstances of negative equity, at the margin a rational investor would be predicted to exercise her put option to default more readily than a homeowner in a positive equity position. Empirical studies have generally supported the theory of rational default as having explanatory power for many mortgage defaults.[99] For example, homeowners are less likely to default in areas of faster home price appreciation than in

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[98] *Id.*

[99] Kerry D. Vandell, *How Ruthless Is Mortgage Default? A Review and Synthesis of the Evidence*, 6 J. HOUSING RES. 245 (1995); James B. Kau & Donald C. Keenan, *An Overview of the Option-Theoretic Pricing of Mortgages*, 6 J. HOUSING RES. 217 (1995); Patric H. Hendershott & Robert Van Order, *Pricing Mortgages: An Interpretation of the Models and Results*, 1 J. FIN. SERVICES RES. 19 (1987).

otherwise-similar areas with slower appreciation.[100] Numerous studies conducted during the financial crisis found that a major reason for the large number of foreclosures that occurred at that time was the dramatic drops in home values and large number of homeowners in a negative equity position who chose to default on their mortgages, even when they could pay.[101] As a result, one of the major precipitating causes of the foreclosure crisis was the deterioration of down-payment requirements and increase in cash-out refinancing, both of which made it more likely that borrowers would fall into a negative equity position when housing prices later declined.[102]

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Consumers are also more likely to exercise their option to default when the benefits of defaulting increase.[103] For example, in most states if a borrower defaults on her mortgage, the lender can not only repossess the collateral and sell and apply the value to the outstanding debt, the lender can also sue the borrower personally for any remaining deficiency. In some states, however, the lender is limited only to foreclosing on the home

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[100] 1 Mark Doms, Frederick Furlong & John Krainer, *House Prices and Subprime Mortgaged Delinquencies* 1–2 (FRBSF ECON. LETTER NO. 2007-14, 2007); Brent W. Ambrose, Charles A. Capone, Jr. & Yongheng Deng, *Optimal Put Exercise: An Empirical Examination of Conditions for Mortgage Foreclosure*, 23 J. REAL EST. FIN. & ECON. 213, 218 (2001) (finding higher default rates where home price appreciation slower); Kristopher Gerardi, Adam Hale Shapiro & Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures* 2–3 (Fed. Res. Bank of Boston, Working Paper No. 07-15, 2008), available at http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf (concluding that dramatic rise in Massachusetts foreclosures in 2006-07 resulted from decline in house prices beginning in summer 2005); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, CRL RES. REPORTS AT 1, 13 (Dec. 2006).

[101] "Strategic default" refers to the practice of intentionally defaulting on some obligations while continuing to pay others. During the financial crisis of 2008, for example, many consumers chose to default on their mortgages while continuing to pay their other loans, such as credit cards, student loans, and car loans. In most instances this was because their mortgage was in a negative equity position and so it was rational for them to stop paying on that asset. *See* Luigi Guiso, Paola Spienza, and Luigi Zingales, *The Determinants of Attitudes toward Strategic Default on Mortgages*, 68 J. OF FINANCE 1473 (2013). It is also bears note that the propensity of consumers to strategically default was positively correlated with credit score, which suggests that sophisticated consumers were those who were most likely to see and act on the incentive to default. *See* EXPERIAN-OLIVER WYMAN MARKET INTELLIGENCE REPORT: UNDERSTANDING STRATEGIC DEFAULT IN MORTGAGES, PART 1 (2009).

[102] Zywicki and Okloski, *supra* note 97; *see also* Yuliya Demyanyk and Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 REV. OF FIN. STUD. 1848 (20110.

[103] *See* Zywicki and Okloski, *supra* note 97.

and cannot reach the borrower's personal assets. In such situations, the cost of default is much lower because the borrower can protect her personal assets. Empirical research has found that the presence of antideficiency laws can substantially increase the frequency of default and foreclosure, especially when housing prices fall (thereby providing the borrower with an incentive to walk away).[104] Most striking is that this incentive effect to default is greatest with respect to higher-value houses, which suggests that wealthier homeowners are most likely to benefit from antideficiency laws because those laws are more likely to respond to the incentives created by antideficiency laws when they have more wealth to protect.[105]

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The theory of rational default, however, is not limited to mortgages; it applies to other consumer financial products as well. Consider payday loans. Payday loans have been noted for their high rate of "rollovers," which occur when consumers fail to pay their balance at the end of the loan term and instead "rollover" the loan for another period. There has been speculation as to why consumers roll over their payday loans, with theories grounded on the assumption that consumers for some reason are forced to roll over their loans, perhaps because of fear of lawsuits, an adverse credit report, or debt collection.[106] This assumption that for some reason consumers are forced to roll over their loan grounds the theory that for some consumers payday loans constitute a "debt trap" that they are unable to escape.[107]

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[104] *See* Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & ECON. 115, 135 (1993).
[105] *See* Andra C. Ghent and Marianna Kudlyak, *Recourse and Residential Mortgage Default: Evidence from US States*, 24 REV. FIN. STUDS. 3139 (2011).
[106] *See* BUREAU OF CONSUMER FINANCIAL PROTECTION, PAYDAY, VEHICLE TITLE, AND CERTAIN HIGH-COST INSTALLMENT LOANS, 12 CFR 1041 (Oct. 5, 2017) (hereinafter "2017 Small-Dollar Rulemaking").; *rescinded and replaced by* CONSUMER FINANCIAL PROTECTION BUREAU, PAYDAY, VEHICLE TITLE, AND CERTAIN HIGH-COST INSTALLMENT LOANS (Jul. 7, 2020).
[107] *Id.*

But as the model of rational default indicates, it is not logically or methodologically sound to simply assume that borrower has no alternative but to roll over her loan. Instead, one should inquire into the relative benefits and costs of choosing to breach the contract by defaulting versus the costs of choosing to perform the contract by *not* defaulting.[108] Of particular note, the 2017 Small-Dollar Loan Rule assumes that for some reason borrowers are "trapped" and therefore forced to roll over their payday loans from period to period instead of choosing to default. But the factual basis of the 2017 rule provides no support for this contention. Indeed, it admits that payday lenders rarely sue delinquent customers and do not report them to credit bureaus, so those sanctions are unlikely to be deterrents to default. The CFPB also speculated that perhaps borrowers do not default because they fear debt collection efforts, but it provided little beyond speculation to support the contention of aggressive debt collection practices by payday lenders. More to the point, even if debt collection practices are aggressive, they are only relevant to the "debt trap" theory if collection efforts are predicted to be sufficiently aggressive *after* a potential default to deter a borrower from opting to defaulting in the first place.[109] Thus, all three potential threats that supposedly lead borrowers to roll over instead of defaulting are possible but empirically unsubstantiated at

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[108] *See* Todd Zywicki and Diego Zuluaga, *Comment on the CFPB's Notice of Proposed Rulemaking on "Payday, Vehicle Title, and Certain High-Cost Installment Loans*, DOCKET NO. CFPB-2019-0006 (May 15, 2019), *available in* https://www.cato.org/sites/cato.org/files/pubs/pdf/zywicki-zuluaga-public-comment-5-15-19.pdf. Among the greatest benefits of choosing not to default is the preservation of the option by the borrower to acquire further short-term loans in future periods.

[109] In the 2017 version of the small-dollar loan rule, the CFPB identified to the relatively large number of complaints registered by payday loan consumers against debt collectors compared to providers of other products as evidence that the threat of aggressive debt collection efforts might induce borrowers to roll over their loans instead of defaulting. From the perspective of determining whether a consumer is caught in a "debt trap" where he or she feels forced to perform instead of breaching, the aggressiveness of collection efforts *ex post* is relevant only to understanding the incentives for whether to perform *ex ante*. Analogously, in the economic theory of crime, the measurement of the deterrent effect of criminal sanctions is the number of people who obey the law and the amount of criminal activity that does not occur, not the frequency or severity of punishment after the fact. *See also* Gary S. Becker, *Crime and Punishment:An Economic Approach*, 76 J. POL. ECON. 169 (1968).

this point. In short, at first glance it appears that the costs of default on a payday loan are actually quite small.

Default rates on payday loans are high, which suggests that many payday loan borrowers are not sufficiently deterred from defaulting that they instead rollover their loans. According to CFPB research, 27 percent of defaults occur without ever making a payment and almost half of all defaults occur on the first or second loan.[110] Many payday loan customers obviously are not deterred by the costs associated with default and do not feel like they are somehow "trapped" in a debt they are "forced" to pay. Instead, this group of consumers apparently believes that the cost of default is smaller than the cost of not defaulting and do not even make a single payment before choosing to default. Indeed, the quick default suggests that many payday loan intended to default at the time they first obtained the loan and had no intention to repay.

Given the seemingly modest predicted costs of payday loan default, why do some payday loan borrowers choose to roll over their loans instead of defaulting? One obvious alternative hypothesis is that these consumers turn to payday loans because they have limited alternative credit options available to them at the time.[111] Payday loans offer a last lifeline of access to credit for many pinched consumers. And one consequence—perhaps the primary consequence—of default on a payday loan is the loss of access by the borrower to future payday loans from that same lender or other payday lenders. Thus, even if a borrower suffered few direct adverse consequences from default (such as a

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[110] CONSUMER FINANCIAL PROTECTION BUREAU, CFPB DATA POINT: PAYDAY LENDING 27 (March 2014). Almost half of defaults occur on the first or second loan. *See id.* at 28; *see also* SUSANNA MONTEZEMOLO AND SARAH WOLFF, CENTER FOR RESPONSIBLE LENDING, PAYDAY MAYDAY: VISIBLE AND INVISIBLE PAYDAY LENDING DEFAULTS (March 2015).
[111] *See* discussion in Chapter 5 of the characteristics of payday loan borrowers, including their limited access to alternative credit products.

further damaged credit rating, lawsuit, or collections efforts), they might still roll over their loan to preserve future access to payday loans. It is not clear why it might be thought useful or accurate to characterize the decision exercise ones option to rollover the loan in order to maintain the option of access to future loans as a "trap." Regulatory efforts focused on reducing defaults, therefore, could have unintended consequences of encouraging lenders to be *more* aggressive in collecting on payday loans in order to reduce the incentives for borrowers to default. It is hard to see how this would improve consumer welfare relative to the status quo.

As this extended example of rational default indicates, before the CFPB or any other regulatory agency intervenes in a market it should first establish that there the purported market failure it observes is one that causes a consumer protection problem and it should accurately define the nature of the problem and the means-ends relationship between the market failure and proffered solution. When consumers are informed about the costs and benefits of making a choice, and respond to those incentives by making the cost-minimizing choice, its not obvious why this creates a consumer protection problem calling for government intervention.

The Taskforce has been able to locate no evidence to estimate the benefits and costs to consumers of performing on their payday loan contracts instead of breaching. It is possible that a threat of lawsuits, adverse credit reporting, or aggressive debt collection practices induce some consumers to roll over their loans instead of defaulting. But that cannot simply be assumed to be true, especially in light of the large number of consumers that do actually default. Alternatively, the decision whether to roll over a payday loan might reflect a rational decision that the marginal benefits of retaining the option of keeping the loan balance outstanding for another term exceed the marginal costs of doing so.[112] The Taskforce recommends that the CFPB conduct research to better understand why consumers choose not to default on payday loans and instead roll them over. Similar research should be conducted for other products under the CFPB's jurisdiction where relevant, to determine whether consumer choices reflect rational responses to existing incentives or some consumer protection problem.

Correctly identifying the source of observed behaviors is crucial not only for properly identifying the nature of the purported consumer protection problem but also to avoid unintended consequences that could harm those consumers intended to be helped. Most important, if a particular behavior results from consumers' responses to incentives and not fraud or some other feature that interferes with understanding, then treating the behavior as resulting from a consumer protection issue could actually exacerbate the problem. For example, although many consumers were victims of fraudulent lending practices that eventually resulted in foreclosure, many other borrowers chose to default strategically, when their homes fell in value and became worth less than was owed on the mortgage. Thus, the presence of antideficiency laws for residential mortgages in some states, which reduced the costs of default and increased the benefits, contributed to the severity of the 2008 foreclosure crisis by providing incentives for homeowners to default on their mortgages when home prices fell especially among those who buy homes for investment purposes or second homes. Yet Dodd-Frank provides specific statutory protections to ensure that more homeowners preserve their antideficiency rights under

[112] *See* Kevin W. Caves and Hal J. Singer, "Re: Docket No. CFPB-2016-0025/RIN 3170-AA40," Economists Inc. (Oct. 7, 2016).

state law where relevant.[113] As a result, this provision will likely have the effect of *increasing* foreclosures during a future financial crisis that resembles the last one where property values fall. Thus, the failure to appreciate the logic of how consumers respond to financial incentives could ironically exacerbate the problem that the legislation was intended to address.

B. Market Failure and Government Intervention

Not every decision by a consumer necessarily results from a market failure and not every market failure that could reduce consumer welfare raises a consumer protection problem as opposed to some other source of market failure. Before intervening in a market the government should take care to determine the extent of any consumer harm, the causes of that harm, and that the benefits of any proposed intervention will actually improve outcomes for consumers. Although regulation and enforcement by public agencies can be uniquely valuable in protecting consumers when other institutions cannot, public action also raises unique concerns that other mechanisms do not. In particular, private market activity and common law can be relatively nuanced and tailored to the preferences of buyers and sellers of financial products or any consumer product. Regulation often displaces voluntary transactions between consumers and providers that are generally presumed to be mutually-beneficial. Moreover, the vast reach of regulatory authority and its ability to cover broadly across the market raises concerns about outside special interest influence and internal biases of regulatory agencies themselves can lead regulation to depart from its stated purpose of advancing overall consumer welfare.

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These tradeoff suggest that before intervening, and agency should conduct a three step analysis and ask:

[113] *See* Dodd-Frank §1414 ("Protection Against Loss of Anti-Deficiency Provision").

1. Is there a market failure?

2. Is there a feasible solution to address the market failure?

3. Will the benefits of the proposed intervention exceed the costs, including all unintended consequences associated with the intervention?

As this analysis makes clear, not all market failures can and should be the subject of regulatory intervention. Only those market failures that can be corrected through interventions where the benefits exceed the costs of not doing so.

1. Determine the Presence and Nature of the Market Failure

First, the nature of the market failure must be identified accurately in order to propose a useful remedy. In general, economists have identified four categories of potential market failure that are relevant to the current discussion: (1) Asymmetric information, (2) Externalities, (3) Market or monopoly power, and (4) Public Goods. In the world of consumer financial protection, the primary source of market failure is asymmetric information, i.e., where the provider of a product or service has more information about the product and its terms or attributes than does the consumer. The terms and attributes of many consumer financial products are irreducibly complex, which reflects the complex and varied uses of these products by consumers. Credit cards, for example, contain numerous different features and attributes that reflect the varied uses of these products by consumers, such as annual fee, interest rate, benefits, credit line, and many other prices for various services such as cash-advance fees, late fees, etc. By contrast, payday loans are relatively simple products, typically featuring one basic price—the periodic finance charge—with perhaps a few other terms. Since the 1970s, the

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most common concern about market failure in consumer finance markets has been asymmetric information, which has been addressed primarily with information-based remedies.

Usury laws provide an example of substantive regulation. Consumer financial protection in the United States was traditionally provided at the state level, which was ordered around the idea of substantive regulation by the government of the terms and prices of consumer credit products. Usury ceilings, at root, rested on the idea that a consumer should not be permitted to pay above a certain price for any consumer loan, even if fully informed about its price and even if the consumer thought it was in his personal welfare to use the product.[114] As a result, the allowable interest rate on consumer loans was capped by law, even if the equilibrium market-clearing price was not, so that consumers ended up paying essentially the same overall effective price.

Beginning in the 1970s consumer financial protection regulation began to migrate away from substantive regulation of terms and prices that mandated regulatory-imposed product design. This new approach made providers and consumers the primary architects of product design through voluntary market interactions instead of government regulators. For example, as discussed in chapter 10, deregulation of interest rates on credit cards enabled greater variety in offerings to consumers, as banks based in some states could offer cards with higher interest rates and no annual fee while others were forced to offer cards with an annual fee but lower interest rate capped by regulation. As

[114] Oddly, this mindset about consumer financial products did not then and does not now carry over to other consumer purchases. For example, although usury ceilings might limit the price that could be charged on a car loan, there is no similar price cap on the price of the actual car, even though overpaying for a car might cost a consumer far more money overall than an interest rate that exceeded the statutory cap. As noted above, the NCCF also made this observation in its Report and noted that it was unable to discern any reason why the maximum price of credit should be set by law but not the price of hamburgers or other consumer goods.

noted above, this evolution in regulatory strategy arose in response to the growing consensus that substantive regulation such as usury ceilings, were ineffective at best at protecting consumers and counterproductive at worst.

These developments in economic understanding were matched by societal changes during that era that eliminated many of the paternalistic attitudes and stereotypes that animated many of these traditional regulations. Most notable, women as a group historically were seen as less-capable of managing finances than men, a stereotype that rested on the longstanding assumption that women had poor math skills compared to men and that therefore aggressive retailers would goad them into unnecessary purchases and heavy debt.[115] Paternalistic restrictions on low-income consumers' ability to access credit rested on similar unfounded negative stereotypes about their alleged lack of mental acuity and impulse control, often mixed with a large dose of negative implied racial stereotyping as well.[116] Echoes of these crude and hurtful stereotypes of particular groups of Americans are still heard today in many paternalistic calls for regulations on consumer choice that are supposedly intended to benefit those who are most affected.

This should not be read to deny the reality that there are certain groups of consumers who are indeed vulnerable cognitively or in some other fashion, such elderly

[115] LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 166 (2001) (noting that installment sellers in earlier generations were criticized by consumer advocates for taking advantage of supposedly vulnerable groups such as "math-impaired females).

[116] *See* David Caplovitz, *Consumer Credit in the Affluent Society*, 33 L. AND CONTEMPORARY PROBLEMS 641, 647 (1968) (asserting without evidence that low-income consumers were lured into taking on excessive debt to engage in consumption, a "deviant system" that "rests in part upon the ignorance of low-income consumers and their vulnerability to fast-talking salesmen," to which middle class families are immune). *But see* Theodore W. Schultz, *Nobel Lecture: The Economics of Being Poor*, 88 J. POL. ECON. 639, 649 (1980) (concluding "poor people are no less concerned about improving their lot and that of their children than those of us who have incomparably greater advantages. Nor are they any less competent in obtaining the maximum benefit from their limited resources"); *see also* Jan M. Newton, *Economic Rationality of the Poor*, 36 HUMAN ORGANIZATION 50, 58 (1977) (concluding that "low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans").

Americans who suffer from cognitive decline as they age or others who are unable to protect themselves. But in a free society and free economy, there should be a starting presumption that adult consumers are autonomous actors who typically know better than governmental central planners what challenges and opportunities they face and how to best meet their family's needs with the actual choices that are available to them at the time and under the constraints they face. Before government intervenes, especially in a substantive fashion, there must be some reason to believe that the market failure is of the type that can be remedied best by replacing the outcome of consumer choice and competition with government mandate and not by less-intrusive measures, such as market responses or common law remedies.

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2. Identify a Proposed Remedy That Responds to a Market Failure

Second, there must be a realistic potential government remedy that addresses the identified market failure. Market failures arising from incomplete or asymmetric information that are not addressed through market solutions, such as advertising, money-back guarantees, or credible third-party verification firms, would be suitable for information remedies, such as required standardized disclosures. Market failures that are believed to flow from non-informational factors, such as alleged cognitive or self-control limits, "externalities," or market power, are potential subjects for substantive regulation to outlaw or limit particular products or practices. These substantive consumer harms arise when the consumer has made a choice that is considered welfare-reducing by third-parties, even if the consumer would have made the same choice if fully informed. Additional information is unlikely to prove effective at changing the consumer's choice under those circumstance, as the harm in question arises from forces such as misaligned

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incentives (in the case of externalities, for example), market power (where the consumer might be fully aware that the price exceeds the competitive price but is unable to effectively do anything about it), or cognitive limitations (that interfere with the ability of consumers to fully comprehend and appreciate the information that they are provided).

Moreover, requiring additional information to be provided might actually be counterproductive from the perspective of the consumer, by increasing their confusion and making more difficult to find what information they actually care about. For example, as discussed in Chapter 7 of this Report, providing information that consumers do not actually value as part of their shopping behavior, but which regulators think consumers *should* value, can distract their attention from important terms that they actually do care about and consider relevant, which can be characterized as "normative disclosure."[117] In turn, by distracting consumers to focus on the information that regulators believe most important, at the expense of information that consumers consider most important, can lead consumers to make inferior choices than they would have without the additional information.

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These two alternative approaches to regulation have been labeled "market-reinforcing" and "market-replacing" regulation.[118] Market-reinforcing regulation refers to regulatory action designed to "promote competition and consumer choice so that consumers can find those products that they think are best for themselves and their

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[117] *See* discussion in Chapter 7; *see also See* Todd J. Zywicki, *The Market for Information and Credit Card Regulation*, 28 BANKING AND FIN. SERVS. REPORT 13 (2009).

[118] *See* Todd J. Zywicki, *Market-Reinforcing versus Market-Replacing Consumer Finance Regulation*, *in* REFRAMING FINANCIAL REGULATION: ENHANCING STABILITY AND PROTECTING CONSUMERS 319 (Hester Peirce and Benjamin Klutsey, eds., 2016); *see also* Brian Johnson, *Deputy Director Johnson's Speech at CFPB Symposium on Behavioral Economics* (Sept. 19, 2019), *available in* [HYPERLINK "https://www.consumerfinance.gov/about-us/newsroom/deputy-director-johnsons-speech-cfpb-symposium-behavioral-economics/"] (describing these two approaches to regulation).

families."[119] Market-reinforcing regulation is consistent with the disclosure-based regulatory strategy of the past several decades that is designed to help markets function and to satisfy consumer demand more effectively by enabling consumers to shop more easily among competing product providers. It also includes vigorous prosecution of fraud, deception, and other unlawful practices that undermine consumer choice.[120]

Market-replacing regulation, by contrast displaces consumer choice and seeks to limit competition and consumer choice "through prohibitions or restrictions on particular products and terms, such as price controls on interest rates (known as usury regulation) or de facto or de jure bans on particular products such as payday loans or bank deposit advance products."[121] Market-replacing regulation reflect decisions by legislators or regulators to supplant the terms for which "the parties would voluntarily bargain with terms dictated by the regulators, and to prohibit consumers from entering into certain contracts even if those consumers believe that purchasing that product furthers their own goals."[122]

3. The Benefits of the Proposed Intervention Should Exceed the Costs

After first determining whether a market failure exists and considering any feasible regulatory responses to that market failure, the final step before taking regulatory intervention should be to determine whether the benefits of any proposed intervention exceed the costs of the intervention, including the costs of any foreseeable and predictable unintended consequences that result from the intervention. Dodd-Frank itself

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[119] Zywicki, *Market-Reinforcing*, *supra* note 118, at 321.
[120] Johnson, *Deputy Director Johnson's Speech*, *supra* note, 118.
[121] Zywicki, *Market-Reinforcing*, *supra* note [NOTEREF _Ref54555234 \h], at 320-21.
[122] Zywicki, *Market-Reinforcing*, *supra* note [NOTEREF _Ref54555234 \h], at 321. Market-replacing regulation has also been called "command-and-control" regulation as it reflects a decision by the regulator to dictate the design of product features. *See* Johnson, *supra* note [NOTEREF _Ref54726532 \h].

requires the CFPB to undertake cost-benefit analysis in determining whether to issue a rule, noting that in issuing a rule the Bureau "shall consider—the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule."[123] Potential costs of intervention should include not only direct costs, such as increases in costs from regulatory compliance that will be passed through to consumers as higher prices and reduced access. But there are additional indirect costs to consumers that result from decreased choice, innovation, competition, and access and inclusion. This Report returns to this theme in chapter 13 in discussing how to apply cost-benefit analysis to proposed regulatory interventions. A few words are in order here, however.

As discussed above and in Chapter 5, one effect of regulatory intervention can be to reduce consumer choice and deprive consumers of more-preferred products and forcing them toward greater use of less-preferred products. Consumer choice and behavior reflect a "pecking order" or ladder of consumer financial products. Losing access to a more preferred type of credit, such as credit cards, tends to lead consumers to substitute to less-preferred (and usually more expensive) products, such as payday loans or pawnbrokers. In addition, as discussed in Chapter 5, demand for these products tends to be relatively inelastic, supply costs tend to be high, and pricing tends to be relatively uniform with limited pricing margins, making it difficult for relatively lower-risk consumers to gain lower prices than relatively more-risky borrowers. The foreseeable consequence of the costs of product substitution, therefore, will not only be the direct cost that results from forcing consumers to rely on more-expensive types of credit but also to reduce their overall access to credit.

[123] 12 U.S.C. §5512(b)(2).

As discussed in Chapter 8, one recurring cost of the structure of regulatory intervention historically has been the adverse effect on competition from creating barriers to entry, regulatory-imposed segmentation of markets among product providers, and other rules that create market power for dominant firms locally or provide competitive advantages for certain providers of consumer financial products relative to others. For example, one important effect of historic state usury regulations has been to limit the effective range of choice for consumers by promoting competition on the margin of the comparative ability of different types of product providers to circumvent the distorting effects of price controls on interest rates, instead of competing directly on price and quality. For example, as discussed in Chapter 10, the dominant position held by retailers in credit provision for many decades reflected the preferential regulatory status they held compared to banks and other financial service providers under the "time-price doctrine" and the ability to offset below-market pricing for credit by raising the price of appliances and other goods typically purchased on credit. This circumvention activity reduced price transparency in markets for both goods and credit as well as limiting consumer choice in credit providers to department stores and other large merchants. With respect to credit card issuers, usury ceilings led to the imposition of annual fees, which were not only economically regressive in their impact but also acted as an effective tax on card-holding by consumers, thereby dampening competition and increasing switching costs by consumers. Where regulation has the effect of dampening competition and creating regulatory-induced increased market power it is predictable that any price increase or decline in supply will be larger than would otherwise be the case.[124]

[124] *See* Zywicki and Zuluaga, *supra* note 108.

Finally, a full accounting of costs should include the costs associated with rationing access to credit. Some of these costs, such as the long-standing and reoccurring presence of illegal loan sharks, are difficult to quantify but the economic and human tolls are unquestionably high. But to this list of costs that result from rationing should also be included the costs of foregone valuable investments, such as the costs associated with being unable to buy or repair important household appliances (such as a clothes washing machine) or reliable automobile transportation. Regulators traditionally have not tried to include those opportunity costs in their overall calculations of the relative costs and benefits of regulation, but a full accounting suggests that they should.

A final factor for regulators to consider is in choosing between market-replacing (i.e., substantive regulation of terms and products) and market-reinforcing rules (such as disclosure rules).[125] Market-replacing rules, in general, can be expected to impose higher costs on providers and consumers than market reinforcing rules. This is because, by definition, market-replacing rules foreclose consumers and providers from entering into voluntary transactions that they desire to enter into. Moreover, regulators face much higher information costs before enacting market-replacing rules because of the likelihood that their unintended costs will be higher than for market-reinforcing rules. Market-reinforcing rules, by contrast, seek to facilitate consumer choice and to enable consumers to find the products and services that they desire, rather than supplanting consumer choice with the preferences of regulators. Thus, even if the new rule increases the costs to certain consumers of contracting for the products and services they desire, they are not foreclosed from doing so by regulatory mandates. Thus, although market-replacing rules might nevertheless have benefits that exceed their costs, the higher costs associated with

[125] *See* Zywicki, *supra* note 118.

those rules suggests that before enacting such rules, regulators should ensure that the proposed rule has substantial benefits that cannot be accomplished or approximated with a more modest rule (such as a disclosure requirement) or no rule at all. On the other hand, where consumer harm cannot be mitigated at reasonable cost through market-reinforcing rules, market-replacing rules might be appropriate. For example, many scholars have criticized the proliferation of disclosures in consumer financial regulation to the degree where they can overwhelm consumers and can be counterproductive to consumer understanding.[126]

On the other hand, one possible explanation for the explosion in mandatory disclosures may be the recognition by regulators of the high costs and unintended consequences that can accompany substantive rules. This, in turn, has reduced the effectiveness and increased the costs to consumers of dealing with a surfeit of disclosures. As discussed in Chapter 7, regulators should be careful before loading on additional disclosures, in light of the many disclosures that consumers already face when trying to use any financial product.

IV. Regulatory Tools

A final challenge for a regulatory agency is the appropriate use of their regulatory tools. When the agency decides that there are some feasible actions it could take that are projected to have benefits that exceed the costs, the agency must determine which of its various tools, alone or in combination, are best suited to the task.

The CFPB is unusual in the large variety of tools that it has at its disposal. As outlined in Dodd-Frank §1021(c), CFPB has five distinct sets of "functions" or regulatory

[126] *See* discussion in chapter 7.

"tools": (1) Regulation, (2) Enforcement, (3) Supervision, (4) Consumer Education, and (5) Policy Research and Development.[127] In addition, the CFPB also uses various informal tools, such as supervision and enforcement guidance, policy statements, and no-action Letters, which are not so much independent regulatory tools but which help to implement those other tools. As far as the Taskforce is aware, few regulatory consumer protection regulatory agencies in the world possess such a wide variety of tools at their disposal in one agency. The FTC, for example, lacks the supervision authority that the CFPB possesses and must follow complex procedures to exercise its general rule-making authority. Most state Attorneys General offices, which are the primary state authorities with respect to implementing state consumer protection laws, posses primarily enforcement powers, with limited research capacity (especially economic research) and consumer education, and virtually no regulatory or supervisory authority, which are left to state regulatory agencies or others.

This unique combination of five tools in one consumer protection agency creates both an opportunity and a challenge for the CFPB. It is an opportunity in that the CFPB can more carefully calibrate the best tool for an identified regulatory task, rather than being forced to jerry-rig an existing limited set of tools to address a problem, such as using enforcement to address problems perhaps better resolved through supervision or rulemaking. On the other hand, possessing several tools that could all be brought to bear on the same question raises the danger of duplicative and inconsistent regulation by different offices within the same regulatory agency. This danger, in turn, highlights the need for diligence and persistence to ensure that various divisions wielding different tools

[127] 12 U.S.C. §5511(c).

are well-coordinated and exercise self-restraint in trying to bring their particular tools to bear on a particular topic.

Reviewing the CFPB's history, it is unclear what its vision and strategy have been and how to determine which tools are best-suited to address particular types of problems. This lack of strategic planning has in some instances resulted in a lack of coherence and consistency across the agency in the implementing some of its rules and regulations. For example, testimony at the CFPB's Symposium on "Abusive Acts or Practices" contended that the CFPB has applied inconsistent definitions of the term "abusive acts or practices" from different divisions of the agency, such as enforcement, rulemaking, and enforcement.[128] For example, the definition of "abusive acts or practices" applied in the 2017 Small-Dollar Loan Rulemaking shows little similarity to the CFPB's use of the term in its enforcement actions.[129] With respect to exercise of its supervisory authority, the CFPB had provided very little information about how the term would be interpreted and applied in that context, largely simply restating the language of Dodd-Frank with minimal additional elaboration.[130] As a result, although each of these three divisions of the CFPB all can lay claim to being in the best position to implement the "abusiveness" standard in some context, the fact that the CFPB possess all three of these powerful tools raises the risk of inconsistent or multiple mandates that generate costs that outweigh the benefits of regulation. The Taskforce commends the CFPB for adopting its policy statement to define what constitutes abusive acts and practices, yet just two months after

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[128] Statement of Todd Zywicki, Prepared for Consumer Financial Protection Bureau Abusive Acts or Practices Symposium (June 25, 2019), *available in* [HYPERLINK "https://files.consumerfinance.gov/f/documents/cfpb_zywicki-written-statement_symposium-abusive.pdf"].

[129] *See* Bureau of Consumer Financial Protection, "Statement of Policy Regarding Prohibition on Abusive Acts or Practices,' Billing Code: 4810-AM-P (January 21, 2020), *available in* [HYPERLINK "https://files.consumerfinance.gov/f/documents/cfpb_abusiveness-enforcement-policy_statement.pdf"].

[130] *Id.*

the policy statement on abusive acts and practices was issued, the Bureau filed an enforcement action that made no mention of the policy statement.[131] Thus, it remains unclear to what extent the CFPB will follow the policy statement in practice.

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In addition, the lack of a clearly-articulated strategy for tool usage has led the agency in some instances arguably to use the "wrong" tool for a particular job. Examples are provided below.

A. Regulation

Regulation is arguably the most extensive and far-reaching power possessed by the CFPB.[132] Dodd-Frank specifically mandated that the CFPB issue rules on particular subjects. The CFPB is also prohibited from issuing any rule establishing a "usury limit" for the extension of credit.[133] Beyond those limits, the CFPB has discretionary rule-making authority with respect to rules to implement any of its enumerated statutory authorities as well as to regulate unfair, deceptive, and abusive acts and practices. Several of the rules issued by the CFPB were required by Dodd-Frank and others were discretionary.

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Regulation generally can be characterized as coming in two different forms, principles-based regulation versus rules-based regulation. Principles-based regulation rests on a set of principles of conduct and outcomes, but which then largely leaves to the regulated parties and their enforcement agencies to decide how to most appropriately implement them. As summarized by Chairman of the Commodities Futures Trading Commission Heath Tarbert, "In general terms, principles-based regulation reflects a

[131] *See Bureau of Consumer Financial Protection v. Fifth Third Bank*, Case 1:20-cv-01683 (United States District Court for the Northern District of Illinois, Mar. 9, 202).
[132] *See* 12 U.S.C. §5511(c)(5) (authorizing CFPB to issue "rules, orders, and guidance implementing Federal consumer financial law"); §12 U.S.C. §5512(b).
[133] *See* 12 U.S.C. §5517(o).

transition away from detailed, prescriptive rules toward high-level, broadly-stated principles that create standards by which regulated firms must operate. Under this approach, firms are responsible for finding the most efficient way of achieving regulatory objectives."[134] Tarbert notes that principles-based regulation aims at the same objectives as rules-based regulation, "It simply does so in a way that is often more efficient and less burdensome than rules-based regulation, leaving space for flexibility and innovation."[135] CFPB's authority to prohibit "unfair, deceptive, and abusive" acts and practices is an example of principles-based regulation, in that it provides a framework of proscribed behaviors that are defined with respect to the harm that those practices cause to consumers.

Federal consumer protection law historically has reflected principles-based regulation, most notably the FTC's historic power to enforce prohibitions on "unfair and deceptive" acts and practices. Although those terms appear to be vague and uncertain, the FTC has refined their scope and meaning over many decades of enforcement and other activities that have updated and amended those terms in a common law fashion to suit emerging threats to consumers.

Rules-based regulation, by contrast, is highly prescriptive and typically provides not only detailed requirements but details the means to accomplish them as well, even if alternative less-expensive and more-effective means might be availalbe. The long, detailed prescriptive menu of mandatory disclosures, both in content and format, required by TILA, RESPA, and other similar regulations exemplify the dominance of rules-based regulation over the last several decades. As the example of prohibiting "unfair" acts and

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[134] Heath P. Tarbert, *Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation*, 10 HARV. BUS. L. REV. 1, 5 (2020).
[135] *Id.* at 6.

practices on one hand compared to prescriptive mandatory disclosure on the other, the CFPB's status as a financial consumer protection regulator sits at an conceptual crossroads between the FTC's principles-based tradition of consumer protection and the banking regulators' rule-based approach to financial regulation.

CFPB's status as both a financial regulator and consumer protection regulator presents the challenge of integrating these two disparate approaches into a coherent regulatory approach. This challenge is exacerbated by the diversity of the industries that CFPB regulates. Banks and credit unions traditionally have been regulated primarily though a rules-based approach and their prudential regulators also often tend toward that approach. Debt collectors and small-dollar lenders, by contrast, were traditionally regulated by the FTC and state attorneys general, which tended toward a somewhat more principles-based approach focused on unfair and deceptive practices. Because the CFPB regulates both types of institutions, it has tended to draw fire from both sides, as banks have sought greater specificity in their obligations via rules-based regulation while participants in other industries have complained of the undue complexity and regulatory burden of detailed rules-based regulation, which they contend stifles their ability to serve their heterogeneous customer base effectively.

A principles-based approach to regulation offers the potential for substantial benefits compared to traditional rules-based financial regulation. First, principles-based regulation has a greater degree of flexibility and adaptiveness to technological and social change that is more difficult with rules-based regulation. Rules-based regulation, by contrast, runs the risk of quickly becoming obsolete in response to changes in technology, the economy, or consumer preferences. Updating and amending rules-based regulation is an expensive and time-consuming process. Principles-based regulation also can also reduce regulatory cost by offering multiple pathways to the accomplishment of the same regulatory end and otherwise permitting regulated parties to search for the most-efficient and effective way of attaining the desired end.[136] Rules-based regulation also requires much higher levels of regulator knowledge to be effective, both as to the technological and economic factors that impact the rule but also regarding the most effective means-end fit between the end goal and the means chosen to accomplish it.

On the other hand, principles-based regulation can create anxiety and uncertainty for the regulated community especially for financial institutions long accustomed to more prescriptive regulation. This anxiety might especially be the case where the principles-based regulations are backed by the threat of enforcement with substantial potential penalties attached. Poorly designed and implemented principles-based regulation can create a chilling effect as regulated parties avoid the general zone of uncertainty that is created by the principles-based regulation. In doing so, the provider may eschew consumer-benefiting activities. Regulatory uncertainty could be especially counterproductive if those most impacted by the deterrent effect are higher-risk consumers who often benefit most from new innovations.[137] Principles-based regulation can also be problematic in the hands of an agency, such as the CFPB, which possesses a wide range of regulatory tools (regulation, enforcement, and supervision) and which is organized internally around those tools. The lack of precision provided by principles-

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[136] The debate between the use of "performance standards" or "design standards" in regulatory theory is a subset of the debate over principles-based versus rule-based regulation. *See* Laura Montgomery, Patrick A. McLaughlin, Tyler Richards, & Mark Febrizio, *Performance Standards vs. Design Standards: Facilitating a Shift toward Best Practices*, MERCATUS CENTER WORKING PAPER (2019).
[137] *See* discussion at *supra* note [NOTEREF _Ref54728687 \h] and accompanying text (discussing tradeoff between Type-I and Type –II errors).

based regulation (as opposed to rules-based regulation) can result in conflicting regulatory interpretations emanating from different offices of the agency. The example discussed above regarding the CFPB's seemingly inconsistent definitions of the term "abusive" when used in the context of regulation versus the context of enforcement illustrates the challenge of making principles-based regulation coherent across the agency. Lack of predictability with respect to principles-based regulation can be especially challenging in the context of CFPB rulemaking, as Dodd-Frank authorizes state attorneys general under certain circumstances to enforce CFPB regulations and to pursue the expansive remedies provided by Dodd-Frank. This inability to exercise tight control over the enforcement CFPB rules could deter rulemaking where it might otherwise be optimal and lead the CFPB to use more informal guidance and the like.

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The CFPB has in some instances engaged in rulemakings that contain unusually detailed and specific rules-based mandates and restrictions. For example, in its 2017 Small-Dollar Loan Rulemaking, the CFPB not only required that payday lenders and auto title lenders determine that certain borrowers in certain circumstances have the "ability to repay" their loans before issuing them credit, the CFPB actually went further and dictated to the industry specific underwriting and ability to repay model that they essentially were required to use to make that determination.[138] Principles-based regulation, by contrast, could have permitted the regulated parties greater flexibility to apply their own underwriting model to reach the desired goal.[139] This decision to mandate not just an

[138] A distinct question is whether the primary reason for a particular borrower's default on payday loans reflects the borrower's inability to repay the loan or a decision to rationally default and whether prescribing an ability-to-repay test would materially impact the default rate.
[139] To be sure, monitoring default rates might also have adverse consequences for consumers if it encourages lenders to be more aggressive in collections in order to reduce their default rates.

outcome but a particular underwriting model illustrates the high information costs needed for rules-based regulation to be effective.

Although rules-based regulation has its virtues and has long-dominated the financial regulation sector, the accelerating speed at which technology, society, and the economy are changing is increasingly incompatible with the detailed and inflexible nature of rules-based regulations. Moreover, as the mandates and requirements of the regulatory state have become increasingly dense and complex, even the primary purported virtue of rules-based regulation—their apparent clarity and predictability—has become less certain because of possible competing mandates and high compliance costs. Moreover, even if rules-based regulation increases predictability in the short-run, the constant need for updating those rules in response to external technological, market, and social changes increases unpredictability across time.[140]

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The sentiment of the Taskforce is that the CFPB should, in general, direct its attention to greater use of principles-based regulation instead of rules-based regulation. In general, the CFPB should use its rulemaking power to provide a framework to be used in cooperation with its other tools, instead of viewing regulation as a single comprehensive final statement of its position on an issue. The CFPB should be conscious of avoiding the production of overly detailed and overly prescriptive rules that constrict flexibility. Overly-prescriptive rules also quickly become obsolete and require chronic updating,

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[140] *See* BRUNO LEONI, FREEDOM AND THE LAW (expanded 3rd ed., 1991). This uncertainty is heightened in the case of the CFPB by its unique single-director structure and limited Congressional oversight, which tends to amplify swings from one Director to another, unlike agencies with multi-member commission structures, which tend to promote greater stability and more dampened swings in policy. *See* Zywicki, *Savior*, *supra* note [NOTEREF _Ref54548330 \h]. The decision by the United States Supreme Court in *Seila Law v. Consumer Financial Protection Bureau*, 591 U.S. __, 140 S. Ct. 2183 (2020) will likely amplify this tendency for large swings in policy. *See* STEARNS, MICELLI, AND ZYWICKI, *supra* note [NOTEREF _Ref54727558 \h], at 734-750 (discussing dynamics of two-stage elections and implications for regulatory policy over time).

producing cost and uncertainty.[141] Within this broad framework, enforcement can be seen as a primary tool of clarifying the application of those principles to specific fact situations and updating the applicability of those principles in light of technological, social, and economic change.

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At the same time, the Taskforce recognizes that by potentially creating uncertainty for the regulated community, created by greater reliance on principles-based regulation can have costs for consumers as well. As a result, the Taskforce encourages the CFPB to be proactive in providing guidance, policy statements, and other informal and flexible means to reduce the uncertainty to the regulated community.[142] In this vein, the Taskforce recognizes the many valuable initiatives that the CFPB has undertaken to reduce regulatory uncertainty. For example, in June 2020, the CFPB launched a Pilot Advisory Opinion program designed to increase the predictability of the CFPB's regulatory posture.[143] Through its Office of Innovation, the CFPB has developed a No-Action Letter Program that is available to clarify the CFPB's enforcement posture with respect to certain acts and practices, particularly designed to encourage innovation designed to improve consumer welfare. In January 2020, the CFPB issued a policy statement "Regarding Prohibition on Abusive Acts or Practices."[144]

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An additional potential mechanism for reducing uncertainty would be greater use of regulatory "safe harbors." Although Taskforce recognizes the potential value of safe

[141] The Taskforce's recommendations on the E-Sign statute illustrate the dangers of prescriptive rules that can lock-in prescriptive rules and impose unnecessary costs on consumers and industry.
[142] *See* Tarbert, *supra* note 134, at 6 ("Principles can be fleshed out by rules or other forms of guidance (both formal and informal) as appropriate).
[143] Bureau of Consumer Financial Protection, "Advisory Opinion Pilot" (June 16, 2020), *available in* [HYPERLINK "https://files.consumerfinance.gov/f/documents/cfpb_advisory-opinions-pilot_fr-notice.pdf"].
[144] *See* Bureau of Consumer Financial Protection, "Statement of Policy Regarding Prohibition on Abusive Acts or Practices" (January 21, 2020), *available in* [HYPERLINK "https://files.consumerfinance.gov/f/documents/cfpb_abusiveness-enforcement-policy_statement.pdf"].

harbors in theory, we are also wary of their overuse in practice. It is difficult to define the scope of a safe harbor in a principles-based fashion instead of an ad hoc, somewhat arbitrary carve-out. Because of their often-arbitrary and unprincipled nature, these ad hoc safe harbors often reflect the successful lobbying efforts of influential special interests as much as any principled foundation. Moreover, just as rules-based regulation itself tends toward encrustation, obsolescence, and difficulty in changing, safe harbors are often clearly-defined rule-based exceptions and can have a similar effect. Once a safe harbor is created, it can be difficult to modify as circumstances change, in part because of the efforts of special interests to protect their preferred regulatory status. Thus, although the Taskforce recognizes the potential benefits of regulatory safe harbors as a potential response to heightened use of principles-based regulation, it also urges regulators to use care in drafting and enforcing their rules, rather than relying on safe harbors.

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B. Enforcement

The CFPB's second primary tool is enforcement.[145] Enforcement serves two functions for a regulatory agency. First, enforcement is an important tool to deter wrongdoing and provide recompense for injured consumers for violations of law or regulations. Second, it is an important tool to support regulation, especially principles-based regulation. Under this second element, regulation primarily outlines a principles-based regulatory framework and enforcement (along with guidance, policy statements, and other devices) can be used to flesh out the application of those principles to specific fact situations. Enforcement can also be an important tool for updating regulatory

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[145] *See* 12 U.S.C. §5511(c)(4).

principles and applying those principles to new situations and technologies, and to protect consumers from new and emergent threats.

On the other hand, enforcement should *not* be seen as a substitute for rule-making and "regulation by enforcement" should be avoided as a means of setting standards for an industry or changing widespread industry practices. Just as regulation should be somewhat abstract and should not try to anticipate and regulate every single detail and contingency that could arise under a rule's potential application to every fact situation, enforcement should be focused on violations of established law and regulations or the clarification of regulatory principles as they apply to particular acts or practices. So-called "regulation by enforcement"—the practice of establishing de facto industry-wide regulatory standards without following the procedural formalities of the standard regulatory process, including the opportunity for a judge to review those standards under the Administrative Procedure Act—raises substantial rule of law and procedural fairness concerns.

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Equally important, enforcement is a poor tool to try to establish broad principles across an entire industry, as enforcement is focused on the acts of one party in one particular case. Given that narrow range of the issues raised by a particular case, regulation by enforcement lacks the rigor of the three-step process outlined above to identify and remedy market failures. Most obvious, sound regulation should be supported by rigorous cost-benefit analysis to ensure that overall consumer welfare will be improved by the regulatory action. Trying to establish broad principles though enforcement actions in a particular case or series of cases, by contrast, potentially end-runs protections to consumers provided by cost-benefit analysis and opportunities to comment on the proposed rule. As a result, trying to set broader policy through enforcement instead of rules makes it difficult to consider and measure the full range of unintended consequences that are likely to result from the action.[146]

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The perils of trying to establish efficient quasi-regulatory rules through enforcement are heightened when the agency seeks to establish broad principles through precedents established through consent agreements rather than fully-litigated cases.[147] Most of the CFPB's enforcement action, like many other government agencies, have been resolved by consent agreements and have not been fully litigated to judgment. By their nature, consent agreements generally provide only limited and largely one-sided conclusory information regarding the factual underpinnings of a case rather than a complete public record.[148] While the limited nature of the public record is not problematic in establishing the foundations for the application of liability and remedies in a particular case, it is less reliable when serving as a precedent for future enforcement actions. In addition, while consent agreements can provide some guidance as to what the agency considers illegal behavior, unlike an adjudication before a judge, consent agreements do not provide any precedent or information about what is *not* illegal behavior. One practice adopted by some agencies to provide guidance as to behaviors that will not incur liability is to publish "Closing Letters," announcing the termination of an

[146] Consistent with this observation, the Taskforce recommends that major enforcement initiatives be subjected to retrospective review to estimate their overall effects on the market including unintended consequences, similarly to retrospective review of regulations.
[147] *See* Jan M. Rybnicek and Joshua D. Wright, *Defining Section 5 of the FTC Act: The Failure of the Common Law Method and the Case for Formal Agency Guidelines*, 21 GEO. MASON L. REV. 1287, 1293-97 (2014).
[148] In many instances, of course, the absence of a public record is at the request of the defendant, which is not problematic for resolving the case. It is problematic, however, when extrapolating the "precedent" of a settled case to new fact situations.

investigation without any allegation of illegality.[149] The CFPB should consider adopting a similar device to provide further guidance of types of practices that are thought to *not* be improper.

Moreover, unless rigorously monitored by senior management, trying to establish precedents through enforcement actions runs a risk of sending conflicting and inconsistent messages to regulated parties as to the substantive standards of liability and the damages and remedies that might assessed for violations. For example, testimony provided during the CFPB's Symposium on Abusive Acts and Practices expressed frustration with perceived uncertainty and unpredictability with respect to the CFPB's enforcement posture, both regarding the substantive definition of "abusiveness" in isolation as well as the relationship between "abusive" acts and practices on one hand and unfair and deceptive practices on the other.[150] For example, reviewing CFPB's consent agreements in various UDAAP actions, it is difficult to discern any particular pattern as to how the CFPB defines abusive behavior, as distinct from unfair and deceptive behavior, as many consent agreements seemingly defined abusive as more or less coterminous with unfair and/or deceptive practices, yet other cases with facially-similar fact patterns resulted in only counts for abusive behavior and still other cases only include allegations of unfair and/or deceptive practices.

Given this uncertainty, the Taskforce recognizes the CFPB for its proactive steps to clarify these questions through its Policy Statement on Abusive Acts and Practices. That sort of guidance not only helps to reduce uncertainty to the regulated community but

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[149] *See* Federal Trade Commission, "Staff Closing Letters," *available in* [HYPERLINK "https://www.ftc.gov/enforcement/cases-proceedings/closing-letters-and-other-public-statements/staff-closing-letters"].
[150] *See* BUREAU OF CONSUMER FINANCIAL PROTECTION, STATEMENT OF POLICY REGARDING PROHIBITION ON ABUSIVE ACTS OR PRACTICES (Jan. 24, 2020) (summarizing testimony and conclusions of CFPB).

also provides internal guidance to the CFPB's enforcement attorneys to identify priorities to allocate the CFPB's limited investigation and enforcement resources to target those behaviors that are considered most harmful to consumers and to ensure greater consistency across cases.[151] Moreover, as with rulemaking, uncertainty regarding the CFPB's enforcement posture can potentially deter acts, practices, and innovations that could be beneficial to consumers because of uncertainty as to how they will be viewed by the CFPB. As noted above, the CFPB's adoption of additional mechanisms for providing additional guidance, such as Advisory Opinions, No-Action Letters, and other guidance regarding its enforcement protocols and priorities, have been useful to increase predictability.

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Principles of preventing and remedying consumer harm while not discouraging beneficial conduct should guide the CFPB's approach to enforcement remedies. As with excessively broad or uncertain standards of substantive liability, excessive or unpredictable penalties for alleged violations can deter actions or the development of products and services that could provide benefits to consumers. To deter harmful behavior but not create excessive or unpredictable liability that could deter beneficial behavior, therefore, remedies should be predictable and should be grounded in consumer harm.[152] In order to gain optimal deterrence, the harm calculation should be adjusted upward to compensate for the probability that the harmful conduct will go undetected or

[151] *See* Statement of Todd J. Zywicki, Abusive Acts and Practices, *supra* note 128.
[152] *See* James C. Cooper and Bruce H. Kobayashi, *Equitable Monetary Relief Under the FTC Act: An Opportunity for a Marginal Improvement*, George Mason University Law & Economics Research Paper Series, 20-06 (March 2020), *available in* [HYPERLINK "https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3549899"].

unsuccessfully prosecuted.[153] Wherever relevant, grounding remedies in consumer harm also implies that any offsetting benefits that the consumer might have received should be considered as part of the economic damages that are recovered.[154] In reading many CFPB enforcement cases, it is not always evident how the CFPB arrived at the damages it seeks in particular cases or the degree to which the damages sought are grounded in consumer harm.

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Without knowing predictably the scope of damages that the CFPB is likely to pursue in the event of consumer harm, CFPB attorneys and regulated parties will have difficulty discerning what harms the CFPB considers to be, on net, most harmful to consumers and to which limited enforcement resources should be allocated. Therefore, in order to more rationally prioritize internal enforcement resources and to be careful not to deter socially beneficial economic activity, the CFPB should consider providing more clarity and guidance to regulated parties. Other financial regulators, for example, identify the relevant factors they will consider in setting remedies through a public matrix or some similar device. Although those matrices are not binding on the agency, they do provide information to regulated parties as to the greatest concerns of their regulators and the risk of liability exposure when establishing internal processes and procedures and allocating scarce internal resources toward regulatory compliance.

C. Supervision

[153] *Id. See also* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); A. M. Polinsky and Steve Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869 (1998).

[154] *See* Cooper and Kobayashi, *supra* note [NOTEREF _Ref54728884 \h].

A third tool possessed by the CFPB to carry out its mission is supervision.[155] Although government inspections are a common tool of consumer protection enforcement, the CFPB's authority to engage in ongoing supervision to the extent it does is unusual. Moreover, although supervision is quite familiar to depository institutions, it is somewhat novel for non-bank entities. The presence of a supervisory power for consumer protection purposes further reflects the unusual nature of the CFPB as a hybrid of a consumer protection and financial regulatory agency in using a conventional tool of prudential regulation to further the CFPB's mission of consumer protection.

Dodd-Frank's rationale for providing CFPB with supervisory authority is unclear and the precise objectives that supervision is designed to accomplish is also unclear. According to Dodd-Frank, the purposes of supervision are to "assess[ ] compliance" with the law, obtain information about the activities and compliance systems of the entity, and "detecting and assessing risks to consumers and to markets for consumer financial products and services."[156] According to Dodd-Frank, the primary purpose of supervision is "based on the assessment by the Bureau of the risks posed to consumers in the relevant product markets and geographic markets."[157] Dodd-Frank lists several considerations that the CFPB should take into consideration in making this assessment. Notably, however, Dodd-Frank does not specifically instruct CFPB to make an explicit cost-benefit consideration in determining which institutions to supervise and how to conduct supervisory policy.

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155 *See* 12 U.S.C. §5511(c)(4); 12 U.S.C. §5514 (providing supervisory authority over nondepository institutions); 12 U.S.C. §5515 (supervisory authority over banks, thrifts, and credit unions with more than $10 billion in assets).
156 *See* 12 U.S.C. §5514(b).
157 12 U.S.C. §5514(b)(2).

The supervisory authority is unrelated to the rationale for the traditional supervisory authority over banks by prudential regulators. Exercise of supervision by regulatory authorities over banks evolved into its current form in response to the implementation of the system of deposit insurance that began as part of the New Deal.[158] The availability of deposit insurance to protect small creditors of the bank (depositors) is gives rise to a moral hazard problem, that the bank will have an incentive to hold insufficient reserves and take excessive risk. Supervision attempts to mitigate this moral hazard problem by monitoring the bank's ongoing performance and risk-taking activities to ensure that the bank is not engaging in overly risky activity. Because lending risks are often difficult to observe externally, supervision provides a mechanism to prevent such behavior from occurring.

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The rationale for providing supervision as a tool for consumer protection is unclear, however, especially with respect to nonbank providers. Unlike the unobservable moral hazard problem that justified supervision by prudential regulators, consumer protection deals with observable harms to third -parties, although not always in ways easy or costless to detect. It is thus not clear what precisely what the architects of Dodd-Frank were seeking to accomplish through granting extensive supervisory authority to the CFPB, including detailed oversight of their compliance procedures, as opposed to

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[158] *See* Eugene N. White, *Lessons from the History of Bank Examination and Supervision in the United States, 1863-2008*, *in* FINANCIAL MARKET REGULATION IN THE WAKE OF FINANCIAL CRISES: THE HISTORICAL EXPERIENCE 15, 16 (Alfredo Gigliobianco and Gianni Toniolo eds., 2009). White notes that although examination of banks have existed since the earliest days of the banking system, until the 1970s the primary purpose of examination for much of that time was to reduce the moral hazard problem by reinforcing market discipline and later as a mechanism for effectuating Federal Reserve monetary policy by controlling reserves and lending activity. The modern supervisory structure focused on bank safety-and-soundness arose in the 1970s in response to financial liberalization that exacerbated the moral hazard problem that had previously been controlled through strict regulation of bank's activities. *See also* Donato Masciandaro and Marc Quintyn, *The Evolution of Financial Supervision: The Continuing Search for the Holy Grail* 263, 267, *in* 50 YEARS OF MONEY AND FINANCE: LESSONS AND CHALLENGES (Morten Balling and Ernest Gnan eds., 2013).

providing the CFPB with enforcement and rulemaking authority while allowing supervision to remain an element of the supervision power of prudential regulators. Nor is it obvious from Dodd-Frank how its supervisory power should fit with the CFPB's other more traditional consumer protection powers of regulation and enforcement.

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Given this traditional justification for supervision, the purpose of granting supervisory power is even more puzzling with respect to non-bank lenders, such as small-dollar lenders that offer simple, largely homogeneous products to the public and for which harm is relatively easy to detect through consumer complaints. At the same time, the supervisory process can impose substantial costs and disruption on regulated parties in terms of preparing for and carrying out supervision visits. The supervision office of the CFPB also consumes a large number of resources, as it is the single largest office within the CFPB, employing almost 500 hundred employees in total, with the vast majority of them situated in regional offices around the country, or about one-third of the entire CFPB staff headcount.[159] In light of the significant resource costs for both the CFPB and the regulated community of the supervisory process, the Taskforce encourages the CFPB to articulate more rigorously its overall objectives in using its supervision authority and thereby to estimate the relative costs and benefits of supervision and different supervisory approaches.

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This absence of a clear purpose for the CFPB's supervisory power is reflected in the CFPB's rulemakings regarding "larger market participants." Dodd-Frank does not

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[159] The Enforcement division is the second-largest division within the Bureau, with about 150 employees. The divisions of Regulations, Research, Financial Education, and Markets all have fewer than 100 employees each. *See* Consumer Financial Protection Bureau Internal FY 2020-2021 Approved Staffing documents (Oct. 2020) (reviewed by Taskforce). In total, the Division of Supervision, Enforcement, and Fair Lending has 630 employees, which comprises approximately 43% of the CFPB's total employee headcount of 1459.

establish clear criteria for the CFPB to use in to determine what constitutes a "larger market participant" across markets. In some instances the CFPB has interpreted its charge to focus on a firm's financial receipts and in other situations the criteria is primarily the number of accounts they service.[160] Even where the same criteria are used to identify a larger participant, such as revenues, the amount varies from one market to another but it is not clear what criteria are used to draw the line.[161] The touchstone for the inquiry for drawing the threshold lines is focused on ensuring that the CFPB supervises a sufficiently large number of firms to cover a large percentage of the market. Yet the inquiry does not try to rigorously assess the marginal benefits in terms of benefits to consumers in light of the marginal costs of exercising supervision, whether to regulated firms or in terms of internal resource allocation for supervision as opposed to other Bureau operations.

Another potential cost of the larger-market participant rule is the potential for "threshold effects" around the level established by the regulation. Crossing over the line that identifies a larger-market participant will increase the cost and risk associated with regulatory compliance as well as requiring investments in new expertise and compliance management. "Banks face a discontinuous increase in regulatory burdens as they cross these fixed nominal asset thresholds. As such, they may act to curtail their normal growth

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[160] *Compare* Defining Larger Participants of the Consumer Debt Collection Market, 77 Fed. Reg. 65775, 12 CFR 1090 (Oct. 31, 2012) ("larger participants" are those with over $10 million in receipts, excluding medical debts) *with* Defining Larger Participants of the Student Loan Servicing Market, 78 Fed. Reg. 73383, 12 CF 1090 (Dec. 6, 2013) ("larger participants" are those with more than 1 million active accounts), *with* Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile leasing Activity as a Financial Product or Service, 80 Fed. Reg. 37496, 12 CFR Parts 1001 and 1090 (June 30, 2015) (defining "larger participants" in nonbank auto finance market as those with at least 10,000 aggregate annual originations of auto loans or leases).
[161] *Compare* Defining Larger Participants of the Consumer Debt Collection Market, *supra* note ($10 million in receipts) *with* Defining Larger Participants of the Consumer Reporting Market, 77 Fed. Reg. 42873, 12 CFR 1090 (Sept. 30, 2012) (defining "larger participant" as those with "more than $7 million in annual receipts from relevant consumer reporting activities").

if that growth would put them just above a threshold."[162] Anecdotal reports and some empirical data suggest that some financial providers in some instances might artificially limit their growth to avoid triggering this threshold; alternatively, in order to deal with the discrete jump in costs associated with going over the threshold can create incentives for banks to merge with a larger bank rather than continuing to grow organically in order to capture greater economies of scale in regulatory compliance costs.[163] Although these costs are inherent in setting any regulatory threshold that results in a discrete increase in costs, in setting the threshold level, the CFPB should be conscious not to set the limit too low so that it artificially deters organic growth or encourages otherwise-inefficient mergers and should be diligent about updating those thresholds as needed, such as by adjusting any dollar value thresholds automatically according to inflation.[164]

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D. Education and Financial Literacy

Consumer education and financial literacy can be a powerful tool for empowering consumers to improve their financial well-being and more efficiently shop for the products and providers that best meet their subjective needs. More informed consumers might also be expected to be less susceptible to being duped by fraudulent and deceptive practices.

Consumer financial education, like other types of general education, also has public goods effects that make this an appropriate tool for a government agency, such as

[162] David Hou and Missaka Warusawitharana, *Effects of Fixed Nominal Thresholds for Enhanced Supervision*, FEDS Notes (July 19, 2018), *available in* https://www.federalreserve.gov/econres/notes/feds-notes/effects-of-fixed-nominal-thresholds-for-enhanced-supervision-20180719.htm.
[163] *See* Shradha Bindal, Christa H.S. Bouwman, Shuting (Sophia) Hu, and Shane A. Johnson, *Bank Regulatory Size Thresholds, Merger and Acquisition Behavior, and Small Business Lending*, 62 J. CORP. FIN. 1 (2020); Hailey Ballew, Michael Iselin, and Allison Nicoletti, *Accounting-Based Thresholds and Growth Decisions in the Banking Industry*, __ REV. ACCOUNTING STUDS. __ (forthcoming 2020); Hou and Warusawitharana, *supra* note 162.
[164] *See* Hou and Warusawitharana, *supra* note 162.

the CFPB, to provide. As discussed in Chapter 7, effective disclosure and information about the terms and conditions of certain products helps consumers to make more informed decisions about particular product choices. Consumer education and financial literacy, by contrast, aims at developing consumers' general human capital to improve their ability to build their financial capabilities, improve decision-making, and enable consumers to better protect themselves from harm and to reward high-quality providers of financial services at the expense of low-quality providers. Because no individual financial institution can capture all of the benefits associated with a more-educated and financially literate consumers, there is a potential for underinvestment in those general problem-solving skills. As a result, effective financial education can be a legitimate function for government and the non-profit sector and can be a valuable tool to advance the CFPB's missions of consumer protection, competition, and inclusion.

Moreover, informed and educated consumers also provide external benefits to *other* less-informed consumers by making informed choices on markets by rewarding high-quality providers and driving low-quality providers out of the market. As a result, if sellers are unable to easily distinguish between educated and uneducated consumers, then sellers will tend to compete at the margin for those consumers who shop more aggressively. This will tend to lead to a proliferation of higher-quality providers and higher-quality contract terms in competitive markets. More highly informed consumers can provide external benefits for consumers who are less informed and less sophisticated. Moreover, consumers who lack understanding of financial concepts can harm not only themselves but also might create negative externalities for other consumers and the economy. Financial distress has impact not only on the borrower but also other

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individuals as well. When a borrower is unable or unwilling to repay borrowed funds, those losses eventually must be passed on to other consumers. Taxpayers as a whole subsidize the bankruptcy system. As seen during the height of the late-2000s mortgage crisis, homes that fall into foreclosure can exert a negative impact on the value of neighboring properties.[165] Individuals who fail to save adequately for retirement will draw more heavily on public welfare programs than those who do save. Better-educated consumers might be expected to be less likely to make decisions that lead to financial distress which will benefit both themselves and others.

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Thus, consumer education, like investments in education generally, has elements of a public good that potentially provide a rationale for government action to promote financial literacy. The more equipped that consumers are to make good financial decisions and avoid bad decisions, the larger the overall benefits for society and the economy. A detailed evaluation of the effectiveness of current consumer education programs and curriculum, as well as suggestions for improvement, is provided in Chapter 12. For current purposes, it is relevant to identify the potential role for consumer education as a tool for consumer financial protection in supplementing the three legs of the consumer protection stool. Educated and empowered consumers are the foundation of making competitive markets work better to help push markets toward higher-quality, lower-prices, greater innovation, and more fair practices and contract terms. Better

[165] Such externalities, however, seem to have been substantially overstated during the financial crisis. Research found that these "externalities" arose from reduced investments by distressed homeowners in the foreclosed property and tended to be short lived. Adoption of policies that slowed the resolution of the property from default to foreclosure increased the negative effect of mortgage distress on house prices. Still, default and eventual foreclosure cast a temporary shadow that depressed surrounding home prices. *See* Kristopher Gerardi, Eric Rosenblatt, Paul S. Willen, and Vincent Yao, *Foreclosure Externalities: Some New Evidence*, 87 J. URBAN ECON. 42 (2015).

educated consumers are also less likely to be harmed by fraudulent and abusive practices, thereby reducing the need for subsequent private litigation and government action.

It should be stressed, however, that consumer education is not a substitute for a robust public consumer protection enforcement and regulatory regime, although it can be a powerful complement to other market and regulatory institutions. Consumers face constraints on their time and attention, which limits their patience for developing consumer literacy tools. More important, many consumer financial products are inherently complex and difficult to understand. Most of this complexity is inevitable in the provision of financial products—credit cards, for example, are used for many different functions, including transactions, borrowing, online shopping, security, and many others. Given the varied uses of credit cards, there is a certain irreducible minimum level of complexity. Mortgages are also highly complex, partly because of the inherent complexity and risks of the product but also because of a complex web of regulatory-induced complexity. As discussed in Chapter 7, consumers are bombarded with information and disclosures regarding the goods and services that they consume. All of this means that even the most-informed and diligent consumer is unlikely to be able to read and understand all of the details of all of the financial products (and other products) that she encounters and will be unable to protect herself from all fraudulent activity. Thus, while financial literacy provides a first line of defense against illegal practices and a catalyst for competitive markets, it should be seen as having a role first in making markets work more effectively for consumers and also for complementing other tools and making them more effective.

E. Policy Research and Development

A fifth tool for a financial consumer protection regulator is policy research and development. As noted above, the predicate step toward deciding whether government intervention and regulation is appropriate is to first accurately identify the market failure and the range of possible responses to address it. Finally, the proposed solution should be evaluated to determine whether the benefits of the proposed intervention exceed the costs.

In many instances, however, it is unclear the extent to consumers have actually been harmed and, if so, what the source of that harm is. Moreover, even if the nature of the harm can be identified, in many cases it is not obvious what the appropriate policy response to the proffered harm might be. Sound economic research can be useful to frame these issues and to develop effective and efficient responses to market failures. Research and analysis can also be useful to retrospectively analyze the impact of prior agency actions, or inactions, to determine whether certain policies should be amended, expanded, or curtailed. Although often overlooked in the bright glare of enforcement and rulemaking, an agency's research function supports all of the agency's tools by helping to develop the agency's agenda and priorities and helping to direct the agency's resources to those ends that will best serve consumers.

The research function of agencies has been referred to as "policy research and development" because of its foundational role in providing direction and mission to an agency, to help it identify the greatest opportunities and threats to consumer financial welfare.[166] As former FTC Chairman William Kovacic has noted, the label takes its

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[166] *See* William E. Kovacic, *Measuring What Matters: The Federal Trade Commission and Investments in Competition Policy Research and Development*, 72 ANTITRUST L.J. 861 (2005); *see also* Timothy J. Muris, *Looking Forward: The Federal Trade Commission and the Future Development of U.S. Competition Policy*, 2003 COLUM. BUS. L. REV. 359 (2003).

inspiration from the observation that "These are public sector capital investments that resemble the R&D outlays that a company makes to improve the range or quality of its 'products.'"[167] Kovacic notes that one of the values promoted by policy R&D investments is the creation of "economic precedents," i.e., studies that can evaluate the validity of a hypothesis that can be later relied upon in assessing the wisdom of a proposed policy intervention.[168] Rigorous performance measurement and evaluation of previous interventions can also provide feedback for improved policymaking. As the Federal Trade Commission noted a decade ago, "An agency that intends to be thoughtful and to consider its policy actions seriously must have some ability to analyze the trade-offs inherent in any policy choice."[169] Policy R&D takes on a heightened importance at the CFPB in light of the reality that academic economists have largely abandoned policy-oriented research related to consumer finance in recent decades.

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To be useful, however, it is important that any analysis be independent from the agency's staff that has contributed to or is otherwise invested in the substantive policy. In this vein, the Taskforce commends the CFPB's Office of Research for its recent announcement of a new procedure for external peer review of important Bureau research.[170] The CFPB should consider extending cost-benefit analysis to its enforcement actions as well even if such analysis would be less precise than for rules. Nevertheless, because enforcement actions typically do have any rigorous analysis of tradeoffs as part of its process—unlike rulemaking, in which policy R&D and cost-benefit analysis are

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[167] Kovacic, *supra* note 166, at 862.
[168] *Id.* at 865.
[169] FEDERAL TRADE COMMISSION, THE FEDERAL TRADE COMMISSION AT 100: INTO OUR 2ND CENTURY, THE CONTINUING PURSUIT OF BETTER PRACTICES at p. xiii (Jan. 2009).
[170] *See* Jason Brown, Consumer Financial Protection Bureau, *Bureau Adopts New Procedures for External Peer Review of Important Research*, CFPB.GOV (Aug. 28, 2020), *available in* https://www.consumerfinance.gov/about-us/blog/bureau-adopts-new-procedures-external-peer-review-research/.

embedded in the decision-making process itself—that it is essential for the CFPB to be proactive in conducting research to ensure that its actions are on net beneficial to consumers.

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Of particular importance in strengthening the CFPB's policy R&D functionality is its important series of Symposia on various topics that it convened beginning in 2019. These programs bring together leaders from academia, think tanks, consumer advocacy groups, industry members, and former governmental officials to provide a wide-ranging analysis of areas of importance to the CFPB and its mission and to help develop policy. The CFPB's Symposium on Abusive Acts and Practices, for example, provided the foundation for its later Abusiveness Policy Statement. Symposia and workshops that rely heavily on an array of outside participants can be particularly important in emerging areas as the agency seeks to build capacity and to respond to emerging threats to consumers and opportunities to promote competition and innovation.

As an adjunct to its research function, the Taskforce believes that the CFPB should consider adding an "Advocacy" function to its consumer protection toolkit. Under this approach, the CFPB can bring its expertise to bear to advise other agencies, state and federal policy-makers, and judges about the likely consequences of their actions for consumer welfare, including the effects on competition and inclusion.[171] Few other government offices have the potential depth and breadth of knowledge about consumer financial protection and innovation the CFPB has with respect to the matters under its scope. Advocacy can be particularly important with other financial regulators, which tend to have narrower constituencies than does the Bureau. The CFPB's can be particularly

[171] *See* FEDERAL TRADE COMMISSION, *supra* note 169, at xvi; *see also* James C. Cooper, Paul A. Pautler, and Todd J. Zywicki, *Theory and Practice of Competition Advocacy at the FTC*, 72 ANTITRUST L.J. 1091 (2005).

helpful in this area where other governmental actors are considering taking actions that would be harmful to innovation or competition that would raise prices and reduce choices for consumer. Many proposals clothed in the garb of "consumer protection" are instead promoted by interest-groups to protect themselves from competition. The CFPB's expertise and independence provides with the authority to explain why facially attractive ideas such as usury controls could have adverse unintended consequences for consumers.

F. Internal Reorganization and Effective Use of Regulatory Tools

As should be clear from this discussion, regulatory tools are a means to the end of maximizing consumer welfare broadly described to include consumer protection, inclusion, competition, and innovation. Since its inception, the divisions of the CFPB have been organized primarily around its several regulatory tools, in addition to its enumerated statutorily-mandated offices and other functions.[172] With respect to its tool usage, the CFPB has a division dedicated to Supervision and Enforcement (with subdivisions for Supervision and Enforcement) and a division of Research, Markets & Regulation, with subdivisions dedicated to each of those functions. Thus, for example, all regulations are drafted in the Office of Regulation, regardless of the subject matter. And the Office of Regulation bears no formal overlap with, for example, the Office of Supervision and Enforcement.

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To better align the CFPB's regulatory tools to improve consumer welfare at lowest cost, it is the view of the Taskforce is that the CFPB should consider reorganizing

[172] The Bureau has four statutorily mandated offices, including the Office of Financial Education, which include the Office of Fair Lending and Equal Opportunity, the Office of Service Member Affairs and the Office of Financial Protection for Older Americans. The Bureau also has several ancillary and support functions, including external affairs, legal affairs, and consumer response. These offices are essential to carry out the Bureau's statutory mission but do not raise analytical questions with respect to their organization for the Taskforce to consider.

its internal operations so as to reorganize around the various markets it oversees (e.g., small-dollar lending, mortgages, credit cards, collections and servicing, etc.), rather than organizing around its regulatory tools or functions. In the view of the Taskforce, this step could help the CFPB to develop deeper expertise with respect to the markets, products, providers, and consumers it oversees, and to use its various tools in coordination with one another to advance consumer welfare. If the CFPB rejects this proposal it is the view of the Taskforce that the CFPB should consider taking steps to more formally address some of the problems identified here that arise from its current structure.

The tool-based organizational structure of the CFPB can lead to some potential difficulties in decision-making. Most important, by organizing around tools instead of markets, the current structure of the CFPB makes it difficult to ensure that the optimal combination of tools is being used to protect consumers and promote competition and inclusion at the lowest cost. This can result in some degree of tunnel vision that has prompted some of the more frequent criticism of the Bureau's operation. Most notable, the CFPB was criticized for its perceived practice of "regulation by enforcement," i.e., using individual cases, particularly negotiated consent agreements, to try to impose industry-wide practices on market participants while circumventing the protections provided by the notice and comment rulemaking procedure and subsequent judicial review under the Administrative Procedure Act. Similarly, in some instances CFPB rules have been extremely detailed and prescriptive. For example, in the 2017 Small-Dollar Loan Rule, the Bureau not only required the industry to evaluate a consumer's ability to repay the loan, it dictated a particular formula for doing so, thereby preempting potentially superior or proprietary systems. It is possible that internally organizing the

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CFPB around markets and products, instead of tools, could avoid the tendency for each division to tend to overvalue its own particular tool as providing a comprehensive response to every consumer protection problem.

Moreover, under the current structure it is difficult for any employee or division to develop deep, ongoing familiarity with the developments in any particular market. By combining enforcement and rulemaking (including more informal acts such as guidance or policy statements) within a particular division it becomes more efficient to determine how certain rules are operating in practice and where they might need clarified. It would also make it easier to use tools in a complementary fashion, such as to use principles-based rulemaking (in which the particular division is highly familiar with the principles that animated the rule) to be fleshed out through supervision, enforcement, and other issues. In addition, by linking research functions more closely to particular markets and consumers the Bureau could be better able to anticipate emerging questions in various markets and to do conduct timely policy-relevant research and to prioritize research projects within the division. In short, by organizing around markets instead of tools, the various divisions could develop deeper subject-matter expertise as well as to adjust their mix of tool usage as time goes on. For example, as noted, if the CFPB seeks to regulate small-dollar lending with a focus on eliminating access to various products by consumers who renew their loans for multiple periods, i.e., to eliminate so-called "debt traps," the Bureau should first determine the actual causes of supposed "debt traps," an important research question the answer to which provides a predicate to any regulatory or enforcement action.[173] Instead, the determination was made that such a rule was needed

[173] *See* discussion *supra* at notes [NOTEREF _Ref54729008 \h]-[NOTEREF _Ref54729030 \h] and accompanying text.

and the rulemaking division launched a major rulemaking process, without ever determining the answer to the question of why consumers choose not to default on their payday loans and therefore whether imposing an ability-to-repay rule would improve consumer behavior.

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Organizing the Bureau's operations around markets would have the additional benefit of strengthening its ability to implement a consumer-centered process of analyzing markets and the competitive process. For example, in the eyes of consumers, payday loans are seen to compete on one hand with bank overdraft protection and on the other hand with pawnbrokers.[174] Historically, those various products have been regulated by different regulatory authorities using different approaches (enforcement versus supervision). Yet the optimal regulatory policy with respect to payday loans is tightly intertwined with the accessibility of overdraft protection as those two products compete for customers at the margin. Although navigating the division lines among products can be complicated, situating payday loans, overdraft protection, and pawn shops within a division of "small-dollar products" could deepen the Bureau's understanding about how those various products interact.

The difficulties that can arise from the current CFPB structure is highlighted by the peculiar division of authority with respect to the Bureau's larger market participant rules. As discussed, one difficulty with the Bureau's definition of large market participants is that it is difficult to determine in the abstract what constitutes a larger market participant and where to draw the threshold line to distinguish those institutions that should be subject to ongoing supervision from those that should not. Moreover, once that line is drawn, there remains the question as to whether it has been drawn according

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[174] Clarke and Zywicki, *supra* note [NOTEREF _Ref54729136 \h].

to the correct criteria (to maximize consumer protection and lowest cost to providers and consumers) or in the correct place. Presumably, those rules should be subject to ongoing consideration and perhaps regular formal updating as the Bureau develops new information about the wisdom of the current practice and whether new product markets and providers should be supervised. This information as to whether the criteria or threshold should be adjusted would be most likely to emerge from ongoing communications with the regulated industry, enforcement actions, and research as to emerging threats and developments in the market. This suggests a feedback loop between the costs and benefits of supervision under its current configuration, its complementary operation with enforcement, research as to its relative costs and benefits compared to other tools, and feedback into whether the rule itself should be revised or whether new rules should be issued for new products.

Under the current organizational structure of the Bureau, this process is more cumbersome. The rulemaking division issues rules relative to larger participant criteria and thresholds. Supervision actually allocates its resources to determine how to implement those rules and how to cooperate with enforcement. But the feedback loop from the research division with new information and to the rulemaking division as to whether the rule is working effectively can be less than efficient.

The Taskforce recognizes that reorganizing the Bureau around markets instead of tools would raise new challenges. The division between markets will not always be clear. Organizing operations around markets also will not entirely eliminate the challenges of cross-Bureau coordination: it will simply raise new challenges of coordination across markets instead of coordination across tools. Still, the Taskforce believes that the potential benefits of reorganizing around markets in terms of deepening expertise and increasing the effectiveness of tool usage outweighs these potential coordination costs. For example, although it is possible that over time some inconsistencies could arise in the interpretation of, say, the "unfairness" standard as applied to debt collectors versus credit card issuers, it is the view of the Taskforce that it is more important that such concepts have a standardized and consistent definition when applied to all of the actors in a given market—whether articulated as part of rulemaking, supervision, or enforcement—rather than trying to promote consistency across, say, all regulations even though the standards might differ among rulemaking, supervision, and enforcement within a given market or as applied to particular products or providers.

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Finally, as a further element of this effort to make its use of regulatory tools more effective, the Taskforce also recommends the creation of an Office of Policy Planning ("OPP") within the Bureau to coordinate cross-bureau operations and assessment. OPP could perform a variety of functions. First, it could be the source of an independent cost-benefit analysis functionality in tandem with similar offices within the divisions. Second, OPP could serve as the location for a new competition and consumer protection advocacy function for the Bureau to provide advice to states on how to effectively protect consumers and promote competition and access. Third, OPP could be tasked with special projects, such as retrospective review of major enforcement efforts to determine their efficacy and efficiency. Fourth, and most relevant for the current discussion, OPP could be responsible for promoting internal coherence of policies and priorities throughout the Bureau to ameliorate the potential problems that could arise from the application of consistent standards within markets but the potential for inconsistent standards across markets.

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