Chapter 6: Consumer Financial Protection Principles

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The NCCF identified three overarching goals for a well-functioning, efficient, and fair consumer credit system: (1) To recognize competition as "the key ingredient of a finance industry capable of providing an adequate supply of at reasonable rates," (2) to assure access for all consumers to alternate sources of credit, and (3) to provide a health consumer protection system to "prevent excesses" by creditors against consumers, whatever form those might take.[1] These three basic orienting principles—competition, inclusion, and consumer protection—remain equally valid today as they did fifth years ago.

Competition will be the focus of Chapter __ of this report. Inclusion will be the focus of Chapter __. One particularly important element of the process of fair competition and consumer protection—the provision of information to consumers to help improve choice-making and protect against oppression—will be the particular focus of Chapter __.

This Chapter of the Report focuses on the question of consumer protection. In particular, we focus on several elements of the consumer protection question. First, we briefly review the history of consumer financial protection legislation and regulation in the United States, with a particular focus on the evolution of the role of the federal government in consumer financial protection. Second, we consider the basic economic framework for analyzing consumer financial protection and how consumers benefit from well-designed efficient consumer protection laws and regulations. Third, we talk about the problem of "market failure." Fourth, we discuss various institutional approaches that can be taken toward dealing with market failure, including competitive markets

[1] NCCF at 2.

themselves as a source of market "solutions," common law, and finally public enforcement and regulation. Fifth, we outline principles for whether to intervene in the market process through regulation and how to structure that regulatory response. Sixth, we briefly discuss the tools available to the CFPB in executing its duties and how those various tools can work together to maximize consumer protection and consumer welfare most efficiently. Finally, we consider the question of how to "measure" consumer protection and, in particular, the importance of understanding consumer welfare properly and the importance of using well-grounded theories to test hypotheses about consumer behavior.

I. Historical Background: State and Federal Regulation

In the United States, consumer financial protection traditionally has been provided 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.

Traditionally the federal government had a minimal direct role in consumer financial protection for most consumers and most products. 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. In addition, the federal government used substantive controls (such as ceilings on the interest rates that banks could pay on customer deposits[2]) to further certain economic goals, such as to subsidize the housing mortgage market or as an effort to control inflation through control over interest rates.

The federal role in consumer financial protection changed dramatically beginning in the 1960s and has grown substantially since then. But unlike traditional state regulation, until recently, most federal regulation of consumer financial protection has been disclosure or information-based regulation instead of substantive regulation of the terms and conditions of credit. In recent years, however, the traditional line between substantive-based state regulation and disclosure-based federal regulation has become increasingly blurred, especially with the passage of the Dodd-Frank Act and the establishment of the CFPB. This Section provides a brief overview of these historical developments.[3]

A. State Regulation

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 price ceilings on the interest rate that could be charged on loans, historically known as "usury" ceilings. Many states also imposed limitations on remedies available to creditors in the

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[2] The infamous "Regulation Q" that capped the interest rate that banks and savings & loans could pay on deposits below the prevailing the market rate that otherwise would have been paid gave rise to the practice of banks providing "free toasters" or other benefits to consumers for opening deposit accounts with the bank, a practice that was the source of many jokes during the era.

[3] An extensive discussion is available in DURKIN, ET AL., CONSUMER CREDIT, 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* DURKIN, ET. AL., CONSUMER CREDIT at 483.

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.

Usury laws have been ubiquitous in American history as a *de jure* matter. As a *de facto* matter, however, usury laws were rarely effective in practice and where effective at regulating prices and supply of credit, they were universally condemned as economically harmful, especially to those who were supposedly the intended beneficiaries of those regulations.

Although ubiquitous in theory, usury regulations were largely ineffective in practice and where they were effective at suppressing prices for consumer credit they were universally condemned by economists.

Usury regulations were largely ineffective in practice because when underlying market interest rates rose such that usury limitations were actually binding, states often moved to raise or abolish the ceilings so that they no longer placed a constraint on the market.[6] States sometimes retained an official ceiling but softened the penalty for noncompliance. In many instances laws were simply ignored and enforcement efforts were ineffective because borrowers were unwilling to complain because they benefited by getting access to credit at prices that they were voluntarily willing to pay and thus had

[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] **Cite** Benmelech and MOskowitz 2010

no reason to complain.[7] By 1880, thirteen states had repealed their usury ceilings.[8] Exceptions to usury ceilings also rendered them largely ineffective.[9]

Even where interest rate ceilings were binding, in practice they were ineffective and counterproductive once all of the unintended consequences of the regulations are taken into effect. The intended effects of consumer credit regulations are usually easy to identify: if interest rates are capped at a certain rate of interest, such as ten percent, then lenders subject to the law will largely comply with the law and not lend at rates above the statutorily-fixed limit.

The unintended consequences of usury ceilings are usually predictable as well. Because access to credit is valuable for consumers, as discussed in Chapter 3, where credit is otherwise limited by usury ceilings, consumers and lenders have developed mechanisms to circumvent usury ceilings so that consumers can get access to the products that they need. While these circumventions have made it possible for consumers to gain access to credit, the roundabout and indirect means that they have used has resulted in deadweight loss to consumers and lenders, as they have had to use less efficient mechanisms to try to reach the desired level and variety of credit products.

There are typically three unintended consequences that result from the imposition of usury ceilings and often a fourth.[10] These unintended consequences include: (1) Term repricing, (2) Product substitution, and (3) Rationing. In addition, depending on the form in which circumvention of the price ceilings occurs, usury ceilings can have an adverse effect on competition. Finally, although it is not invariably the case, historically the

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[7] **Cite** Ackerman 1981
[8] **Cite** Horack 1941
[9] *See* discussion *infra* notes __-__ and accompanying text (discussing "time-price" doctrine).
[10] Cite Zywicki, Market for Information (?)

application of usury ceilings in the United States has had regressive distributional consequences, redistributing wealth from lower-income consumers to higher-income consumers.

1. Term Repricing

The first mechanism used by consumers and lenders to evade usury restrictions is the practice of "term repricing." As the NCCF found,[11] and has recently been reaffirmed,[12] the equilibrium price of credit is fundamentally set by supply and demand dynamics in a market, not by regulation. The NCCF found that where the market equilibrium rate of interest is below the statutory ceiling, it is that price that prevails in the market and that prices do not rise to the statutory cap.[13] Where price controls are binding, however, interest rates settle at the statutory cap. That the nominal interest rate is set by the statutory cap, however, does not mean that the equilibrium price is set by legislation as well. Instead, the equilibrium price remains the actual price of credit—where interest rates are constrained, however, other terms of the loan can be adjusted to reach equilibrium. For example, if lenders cannot charge a market rate of interest, they can adjust other terms of the loan, such as requiring a downpayment, demanding more aggressive default terms, requiring security for the loan, adjusting loan maturities, shortening the grace period before payment is due, reducing customer service or other benefits that might otherwise be made available to consumers, and other adjustments that are designed to implicitly raise prices to the market level.[14] When interest rate ceilings

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[11] Cite NCCF
[12] Cite miller and zywicki on payday loans
[13] Cite NCCF
[14] *See* Orville C. Walker, Jr., & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation*, 11 J. OF MARKETING RESEARCH 70, 77 (1974); John J. Wheatley and Guy G. Gordon, *Regulating the Price of Consumer Credit*, 35 J. OF MARKETING 21, 23 (1971) ("Another serious limitation of the power of interest limitation laws or regulation

were binding during the 1970s, credit card issuers responded by assessing annual fees on cards.[15] Many of these implicit price adjustments also had regressive economic effects. For example, lower income consumers are also more likely to be liquidity constrained, and thus it is more difficult for them to come up with a higher downpayment. Similarly, annual fees were usually fixed at a flat rate (such as $40 per year) regardless of income level, purchase volume, or credit limit available, which resulted in lower-income consumers effectively paying a higher price for access to credit cards than higher-income consumers.

2. Product Substitution

Second, not all products have a sufficient number of terms that can be adjusted so as to make possible an attractive market for consumers. For example, although paying an annual fee on credit cards was one way for consumers to circumvent usury restrictions, those offsetting adjustments will not always be feasible. Annual fees, for example, will increase revenues to offset the ability to charge a market rate of interest on revolving balances, but they are an imperfect substitute for interest rates in pricing risk. Thus, without the ability to contract for a market-rate of interest, many riskier borrowers were unable to gain access to credit cards, even if they were willing to pay an annual fee.

The inability to costlessly reprice terms to reach an equilibrium price leads to product substitution. Eliminating the supply to consumers of a particular product (such as

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is that none really controls the price of money or credit. Taken individually, they typically control only a portion of particular transactions—the portion which formally states an interest rate; however, in any such transaction, the true price of money or credit can often exceed the legal limit.")

[15] Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. ___ (1999?). When usury ceilings on credit cards were effectively eliminated by the United States Supreme Court by its 1978 opinion in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, interest rates on credit cards were permitted to settle to their market-clearing price. In order to compete for customers, lenders soon responded by eliminating annual fees on credit cards, and today the typical credit card has no annual fee unless it also is associated with some rewards program, such a frequent flier miles.

credit cards) does not eliminate the underlying consumer demand for credit.[16] As a result, consumers will substitute to alternative, inferior, more expensive products in order to gain access to credit that they need. Through the 1970s, the most obvious form of product substitution was to retail store credit.

The substitution of retail store credit for cash credit resulted from the ease by which retailers could circumvent usury laws by bundling the provision of credit with the sale of goods. Thus, while credit card issuers could circumvent usury restrictions by imposing annual fees, retailers had a more opaque and easy way of offsetting the inability to charge a market rate of interest: by simply marking up the price of the goods that they sold to offset their credit losses.[17] As discussed in Chapter 3, products such as furniture, appliances, radios, pianos, hardware, and other products emerged very early on as products that are frequently purchased on credit. As a result, retailers in states with binding usury ceilings could raise the price of those goods to offset credit losses with minimal loss of business.[18] In fact, retailers generally operated their credit operations at a loss, using them to subsidize purchases and build customer loyalty, and recouped those losses by raising the price of the goods they sold.[19] As a result, cash purchasers (often lower income) were forced to pay a higher price to subsidize credit purchasers who were

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[16] See Chapter 3, *supra*.
[17] *See* NCCF REPORT, *supra* note, at 105-07; Lynch 1968
[18] *See* Wheatley & Gordon, *supra* note, at 24 ("Most retailers admitted to raising prices in direct response to the passage" of a 1968 Washington state initiative that reduce permissible interest rate charges for retailers and banks from 18% to 12%).
[19] *See* NATIONAL RETAIL MERCHANTS ASSOCIATION, ECONOMIC CHARACTERISTICS OF DEPARTMENT STORE CREDIT (1968) (study solicited by National Retail Merchants Association and conducted by Touche, Ross, Bailey & Smart); *see id.* at 50 ("It seems apparent that the average department store would enhance its profits by eliminating the credit function—if it could maintain the same sales volume. Not only would it make a greater profit, but it would be doing so on a much smaller investment, since discontinuing credit services would also eliminate the need for investing capital in accounts receivable."). *See also* NCCF REPORT, *supra* note, at 107, 145-46, and Table 7-18 (discussing National Retail Merchants Association study).

able to pay below-market prices for the credit element of their transactions.[20] Moreover, retailers typically did not limit price increases to products usually sold on credit.[21]

A 1979 study by Dunkelberg and DeMagistris illustrated the product substitution response to state usury ceilings.[22] They examined the composition of consumer credit acquired from different types of lenders in states with a low maximum interest rate ceiling (Arkansas) with two states with higher ceilings (Wisconsin and Louisiana). Their findings are consistent with hypothesis that low interest rate ceiling prompt product substitution toward types of credit that can more easily circumvent usury ceilings. They find that although the total amount of credit held by consumers in the states was approximately equal, the composition among them differed. For example, 49% of all consumer credit outstanding in Arkansas was through retail providers (such as department stores) versus 29% in Wisconsin and Louisiana. Banks, finance companies, and credit unions provided only 51% of credit in Arkansas versus 67% in higher-cap states. Whereas 28% of consumers reported having been turned down for credit in Arkansas, only 12% reported the same in Louisiana. And Arkansas consumers were also more likely to say that retailers were the easiest place to get credit than residents of other states.[23]

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[20] A 1974 study found that of the various margins on which sellers can adjust to offset usury restrictions, low-income buyers were most strongly opposed to increases in the price of the goods purchased. *See* Orville C. Walker, Jr., & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation*, 11 J. OF MARKETING RESEARCH 70, 77 (1974). Higher-income consumers even more strongly opposed the use of retail price increases as a mechanism for circumventing interest-rate price controls than did lower-income consumers. *Id.* at 77-78. Survey evidence by Walker and Sauter found that 70-90% of purchases at department, appliance, and furniture stores between $400-$500 were made on credit. *Id.* at 73.

[21] Wheatley & Gordon, *supra* note, at 24; *id.* at 27 ("Cash customers… have received no benefits. They are probably paying higher prices because most retailers contacted had raised prices on *all* merchandise…").

[22] Cite Dunkelberg and DeMagistris 1979

[23] A 1981 study by Peterson and Falls compared borrowers in Arkansas with borrowers in states with les restrictive rate ceilings and similarly found that Arkansas consumers obtained the same amount of credit in total as those in other states, they acquired a larger percentage of their credit from retailers. They also found

As the NCCF Report observed of this practice of circumventing interest rate ceilings by raising the price of tied goods and services, "[F]orcing rates on sales credit below the level that would be set by the market may involve the forced transfer of a portion of the finance charge into the cash prices of goods and services."[24] The Report continued, "There is no logical reason to select any type of product or service sold by a retailer and legally require it to be sold at a loss. When credit is selected as the required loss leader, the burden of subsidy falls primarily on cash buyers, some of whom may have been unable to obtain credit. Thus state laws that put the price of credit below competitive rates are forcing both the wealthy and the less affluent, who do not use or cannot obtain credit, to subsidize the use of credit by others. Such laws also tend to discourage those who can obtain credit for using cash to buy goods."[25]

Retailers also had a comparative advantage over other creditors as a result of exceptions to usury ceilings that favored them over other lenders. In particular, under the judge-made "time price" legal doctrine, courts held that merchants could sell goods for different prices, a cash price and a higher "time" price.[26] Courts reasoned, "somewhat implausibly,"[27] that the "time" price was simply an offer to the buyer of a different price for the goods, and not a loan.[28] Thus, whereas those who offered cash credit (such as

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that Arkansas consumers acquired a higher percentage of their credit from out of state sources, which suggests that many of them were crossing over to Texas to make credit purchases. RICHARD L. PETERSON & GREGORY D. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Purdue University Credit Research Center, Working Paper 14, 1981).

[24] NCCF REPORT, *supra* note, at 106.

[25] *Id.*

[26] *See* DURKIN, ET AL., CONSUMER CREDIT AND THE AMERICAN ECONOMY, *supra* note at 487.

[27] *Id.*

[28] *Hogg v. Ruffner*, 66 U.S. 116 (1861).

banks or personal finance companies" were limited by usury ceilings, under the "time price" fiction retailers could effectively circumvent limits by offering a "time price."[29]

Induced tying of transactions in goods together with the provision of credit to circumvent usury ceilings also had the effect of dampening competition in both markets, to the detriment of consumers. Moreover, lower-income and higher-risk consumers were hurt the most by this market adjustment because of their inability to acquire credit from other sources. As David Caplovitz noted in his famous book, *The Poor Pay More*, lower income consumers were often at the mercy of retailers would sold shoddy goods (such as home appliances) at inflated prices to the credit-using poor.[30] Caplovitz found that 75 to 90 percent of purchases by low-income households were made on credit. Similarly, a 1968 Federal Trade Commission study found that 93 percent of household goods sales to low-income households were made on credit. The high demand for credit of lower-income and younger households, combined with the lack of competitive supply as a result of usury laws, effectively created market power for the providers of appliances and other household goods for low-income consumers, enabling them to extract even higher prices from those consumers. Thus, lower income households—the supposedly intended beneficiaries of those policies—were actually those most hurt the most by usury restrictions that effectively limited competition from other sources.

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[29] As Robert Shay observed of this distinction, "[T]he justification of the time-price doctrine has always escaped this economist's sense of logic." Robert P. Shay, *The Impact of the Uniform Consumer Credit Code Upon the Market for Consumer Installment Credit*, 33 LAW & CONTEMP. PROBS. 752, 757 (1968). Shay further noted that once installment loans gave way to revolving charge credit for retailers, the time price doctrine was effectively extended by statute in many states to formally permit retailers a higher interest rate than banks issuing credit cards. "The distinction between open-end sale credit, called revolving charge accounts, and open-end credit, called revolving loan credit, is that the credit contract is made with a seller in the first instance and with a lender in the second. Both may issue a credit card which an be used to purchase goods, tub the seller in the first instance is given a higher rate ceiling than the second. This makes no sense, if we disregard the mandate of power politics." *Id.*

[30] DAVID CAPLOVITZ, THE POOR PAY MORE 16-20 (1967). Caplovitz's study was originally published in 1963.

In fact, empirical studies demonstrated that the primary beneficiaries of interest-rate controls were middle-class borrowers, who were able to gain access to credit at below-market rates as usury restrictions reduced demand for credit by making it uneconomical to lend to higher-risk borrowers while simultaneously increasing the supply of funds by diverting lending capital from higher-risk to lower risk markets.[31] In addition, by limiting the ability to allocate credit through market prices, usury laws instead led to greater reliance on nonprice terms, such as a prospective borrowers reputation or connections with a bank, both of which favored higher-income borrowers and created barriers to entry for new firms seeking to provide credit to those with less-established reputations and fewer connections at the bank (such as younger consumers) and potentially increased the ability of banks to engage in invidious discrimination against groups such as women and minorities who lacked those connections.[32] It is thus not surprising that political support for usury restrictions historically has come from middle class voters, not low-income and higher-risk groups.[33]

Indeed, one major explanation for the rapid growth of general purpose credit cards in the post-*Marquette* era (aside from the benefits it provided to consumers) was the opportunity that it provided retailers, especially smaller retailers, to offload the cost and risk of operating credit operations onto banks.[34] In so doing, it also eliminated a competitive disadvantage for smaller companies seeking to compete against larger

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[31] *See* DURKIN, ET AL., CONSUMER CREDIT, *supra* note, at 533; *see also* William J. Boyes, *In Defense of the Downtrodden: Usury Laws*, 39 PUB. CHOICE __ (1982).
[32] *See* Efraim Benmelech and Tobias J. Moskowitz. *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, __ J. OF FINANCE __ (2010).
[33] *See* Boyes, *supra* note;
[34] In addition to the costliness of operating a credit operation and the general risk of nonpayment, retailers were also reluctant to us vigilant collection measures against delinquent borrowers for fear of alienating a customer, as a result, losses could be high. Outsourcing credit operations permits the retailer to gain the benefit of being able to sell goods to consumers on credit but to avoid the unpleasant task of collecting from delinquent borrowers.

department store chains, which could more easily bear the expense and risk of providing its own in-house credit operations.[35]

More recent studies support this finding that usury ceilings produce product substitution. A 2017 study by Melzer and Schroeder examined the impact of state usury ceilings on automobile financing.[36] They found that in states where interest rate ceilings are binding on the price that can be charged for auto credit, automobile dealers provided a higher percentage of car loan financing, especially among riskier borrowers. They also found that the size of the loans made and the loan-to-value of loans made through dealers was higher than those by non-dealers, which suggests that auto dealers offset their inability to charge a market rate of interest by increasing the price of the car to compensate, especially for riskier borrowers.[37] Because banks and other non-dealer lenders lack this opportunity to pack financing costs into the price of the car, they are unable to compete for many customers, especially riskier borrowers. Lacking effective competition from other credit providers, this dynamic might in turn create some degree of monopoly power for dealers, especially in transacting with riskier borrowers, which could enable auto dealers to mark up the price of the vehicle still more to exploit this market power. Ironically, therefore, usury ceilings on auto loans might result in riskier borrowers paying higher effective prices than they would in absence of such restraints.

But product substitution as a result of interest rate ceilings was not limited to greater use of retail credit. Even with the ability of credit card issuers to adjust their terms to offset some of the limits imposed by usury ceilings, such as by imposing annual fees,

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35 NATIONAL RETAIL MERCHANTS ASSOCIATION, *supra* note [NOTEREF _Ref38209927 \h], at 51-52.

36 Melzer and Schroeder 2017

37 Dealers can also circumvent usury restrictions by reducing the trade-in value that they offer to a prospective buyer, which would be functionally equivalent to a price increase on the end purchase. *See* Wheatley and Gordon, *supra* note, at 24.

at the low rates permitted in some states, only the least-risky borrowers could obtain credit cards and bank loans.[38] And while retailers filled the gap for purchase of goods, they could not provide cash credit when needed. In order to meet that need, consumers turned to alternative products such as pawnbrokers, which Peterson and Falls found were "far more prevalent in the Arkansas market than in [Wisconsin, Illinois, and Louisiana] combined."[39] In many states pawnbrokers were regulated under a distinct set of rules that permitted higher interest rates to be charged than for other types of credit. Even where interest rate ceilings constrained what pawn shops could charge, however, pawnbrokers could evade those limits by reducing the price that they offered for the goods pledged.

Recent studies illustrate that this dynamic still exists. For example, Elliehausen and __ examined the effect on consumers of enactment of the Credit CARD Act of 2009 and market responses to it.[40] The law and Federal Reserve regulations that preceded it made it more difficult for issuers to price risk accurately, to which issuers responded by reducing credit lines and cutting off access to credit cards for higher-risk customers.[41] Elliehausen and __ hypothesized that for many of those consumers that lost access to credit cards, their next-best alternative for cash credit would be personal finance company installment loans. Indeed, they found that in the wake of the enactment of the Credit CARD Act, installment loan use by subprime consumers increased, consistent with the hypothesis of product substitution, as loss of access to credit cards pushed those

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[38] Zywicki, *Economics of Credit Cards*, *supra* note.
[39] *See* PETERSON & FALLS, *supra* note, at 16 (comparing Arkansas with Wisconsin, Illinois, and Louisiana); *see also* Donna Vandenbrink, *The Effects of Usury Ceilings*, ECONOMIC PERSPECTIVES 44, 50 (Federal Reserve Bank of Chicago (Date) **Greg and Tom—I thought there was also a Peterson or a Peterson & Falls or Lynch study on this**
[40] Elliehausen cite
[41] Durkin, Elliehausen, and Zywicki cite

borrowers further down the ladder to less desirable products. **Elaborate** eliminating payday leads to pawn shops **elaborate**

3. Rationing and Illegal Lending

A third effect of substantive regulation will be rationing. Term repricing and product substitution adjustments will enable many consumers to still meet their demand for credit, albeit at higher prices and inconvenience than would otherwise prevail. Nevertheless, if the regulatory regime is sufficiently restrictive to limit the supply of credit available, some consumers will experience unmet demand for credit. History indicates that eliminating the supply of credit through usury limitations and other laws does not eliminate demand. Where consumers are rationed in their access to legal credit, experience teaches that they often turn to illegal sources of credit, or "loan sharks."

The broad term "loan shark" has been used over time to describe a variety of forms of illegal lending activity, ranging from "gray market" lenders that made loans at rates that exceeded maximum permitted rates but otherwise operated as relatively legitimate businesses, to organized crime syndicates that lent at exorbitant rates and collected with threats of violence and physical intimidation.[42]

For obvious reasons, the size of the illegal loan shark racket has been difficult to measure over time.[43] One estimate in 1969 by an FBI expert on organized crime claimed that the size of the mafia-controlled illegal loan shark market in the United States was about $10 billion, equivalent to approximately $69 billion in today's dollars, adjusted for

[42] *See* RONALD GOLDSTOCK & DAN T. COENEN, PERSPECTIVES ON THE INVESTIGATION AND PROSECUTION OF ORGANIZED CRIME: EXTORTIONATE AND USURIOUS CREDIT TRANSACTIONS: BACKGROUND MATERIALS (Cornell Institute on Organized Crime, 1978).
[43] *See* Todd J. Zywicki, *The Sanders-AOC Protection for Loan Sharks Act*, REALCLEARPOLITICS.COM (June 9, 2019), [HYPERLINK "https://www.realclearpolitics.com/articles/2019/06/02/the_sanders-aoc_protection_for_loan_sharks_act_140472.html"].

inflation.[44] For purposes of comparison, that estimate is about twice the size of the estimated $32 billion payday loan market (storefront and online combined) in the United States today.[45] A 1968 United States Senate report concluded that although "no reliable estimates exist of the gross revenue that racketeers derive from organized loan sharking" it estimated that loan sharking was organized crime's second largest revenue source at that time, trailing only illegal gambling operations.[46] 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.[47]

B. Federal Regulation

By the time of the NCCF, therefore, the general expert consensus was that despite the ubiquity of usury ceilings and other substantive regulations through time, the costs of those regulations substantially exceeded the benefits for consumers and the economy, and that those costs fell most heavily on lower-income consumers, who were forced to pay

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[44] RALPH SALERNO, THE CRIME CONFEDERATION: COSA NOSTRA AND ALLIED OPERATIONS IN ORGANIZED CRIME (1969).
[45] *See* Eric Wilson and Eva Wolkowitz, *2017 Financial Underserved Market Size Study*, CENTER FOR FINANCIAL SERVICES INNOVATION (Dec. 2017), [HYPERLINK "https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2017/04/27001546/2017-Market-Size-Report_FINAL_4.pdf"].
[46] *See* United States Senate, Committee on Government Operations, Subcommittee on Legal and Monetary Affairs, "Federal Effort Against Organized Crime: Report of Agency Operations" (June 1968).
[47] 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).

higher prices for the goods that they purchased, had access to less competitive credit markets, and in at least some instances, were forced into the hands of illegal loan sharks.

At the same time, the post-War American economy was becoming increasingly national in scope, fueled by falling transportation and communication costs. Local developments in consumer credit markets increasingly impacted the national economy. 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 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.[48] Ubiquitous automobile ownership increased the ease with which consumers could cross state lines to obtain goods and services not available in their home state. By the time of the *Marquette* case, credit card issuers increasingly were soliciting customers across state lines.[49] And an increasingly mobile population relocated across the country, moving not only their lives and furniture, but bringing their credit cards and other credit devices with them.

The growing difficulties of state authorities to keep up with these developments gave rise to increasing calls for a federal role in consumer financial protection. But at the same time, the growing consensus on the baleful effects of usury and similar regulations

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

[49] It appears that the basis of First of Omaha's competitive advantage was that in-state banks subject to the interest-rate cap were forced to charge an annual fee (euphemistically deemed a "privilege fee" or "membership fee") of $10, whereas the out-of-state issuer offered a free card with a higher interest rate. *Marquette Nat. Bank v. First of Omaha Svc. Corp.*, 439 U.S. 299, 304 (1978). As Marquette's lawyer stated at oral argument, "We are injured when a Nebraska bank comes in here and offers its card free to Minnesota residents in order to take—it can afford to offer the card free when you have, when its [sic] permitted to charge an 18 percent rate. If it had to operate at a 12 percent rate it wouldn't be offering that card." *See* Transcript of Oral Argument, *Minnesota and Marquette National Bank of Minneapolis v. First of Omaha Service Corporation*, Case Nos. 77-1258, 77-1265 (Oct. 31, 1978) at 22. First Omaha's lawyer Robert Bork rejoined that if that is the problem then Marquette "would have done better to take their case to an advertising agency instead of a law firm." *Id.* at 34.

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 of transaction-specific information."[50] To be sure, many states also had disclosure laws of one form of another that supplemented substantive rules.[51] "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."[52] Until recently, this disclosure-based regime was the primary approach followed by the federal government to consumer financial protection regulation. The policy foundation and evolution of federal rules governing disclosure regulation is discussed in Chapter 7 of this Report.

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 should be founded on the principle of robust competition and consumer choice and the primary focus of regulation should be to make markets work better for consumers by increasing transparency and consumer choice. Thus, as the federal role in consumer financial protection grew, the federal framework largely rejected substantive regulation of consumer credit terms (with some exceptions[53]) and instead promoted disclosure and information-based regulation as the primary tool for consumer financial protection. The

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[50] DURKIN, ET AL., CONSUMER CREDIT, *supra* note, at 453.
[51] *See* NCCF Report, *supra* at 170-71 (discussing state predecessors).
[52] DURKIN, ET AL., CONSUMER CREDIT, *supra* note, at 453.
[53] *See*, *e.g.*, PAUL SAMUELSON, ECONOMICS 302-03 (1970) **cite Bill MacLeod edition)** (discussing the economic problems caused by wartime controls on interest rates on demand deposit accounts by the federal government that continued after the war).

enactment of the Truth In Lending Act in 1968 is the most notable example of this turn toward disclosure as the primary tool of consumer protection, with substantive regulation in the federal system playing a secondary role when disclosure regulation is not seen as effective.

As the NCCF observed, the logic of substantive regulation fundamentally rests on the idea that politicians can determine better than the free interaction of consumers and financial service providers “who should get credit, how much credit, what kind of credit, and at what price.”[54] The Commission concluded that it could “devise no empirical method”[55] for answering those questions any more than it could establish whether the “price of a hamburger or shoes was ‘far’ at any given time, or that more of either might be better.”[56] 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.[57]

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

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

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[54] NCCF Report, *supra* at 2.
[55] *Id.*
[56] *Id.* at 3.
[57] *Id.* at 3

> (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.[58]

Moreover, "to assure that competition is meaningful," the NCCF endorsed information-based regulation and the consumers "right to know," such as exemplified by Truth in Lending, as a useful corollary to sweeping away anticompetitive barriers.

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

The Commission concluded:

> 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.[59]

These four principles: (1) Competition, (2) Inclusion, (3) Consumer Protection, and (4) Information, that animated the NCCF some 50 years ago remain the fundamental organizing principle of the US consumer financial protection system.

Although, the world around consumer finance has changed dramatically in the past fifty years, the current Taskforce enthusiastically endorses and adopts these timeless principles as the foundations of its analysis in this Report and the Recommendations found in Volume 2 of this Report. Indeed, the next several chapters of the Report will

[58] NCCF Report, *supra* at 2.
[59] *Id.*

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 turn to the principle of access and inclusion. Chapter 10 will focus on the particular role of innovation in promoting competition, consumer choice, and inclusion.

The first foray of the federal government into the realm of consumer financial protection approximately fifty years ago was driven by the increasingly-evident failures of the traditional system of substantive regulation of terms and conditions of credit and the growing obsolescence 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 behind in its efforts to keep up with increasingly novel products and delivery mechanisms that offer great potential to consumers, especially those who traditionally have been underserved or disserved by traditional providers. 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?

II. 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 Financial Reform Act,[60] 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 has 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 includes vast new powers with respect to substantive regulation, not just disclosure regulation.

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, and that would have within it a Bureau of Consumer Credit ("BCC").[61] Failing the creation of the CPA, the NCCF recommended as a backup plan the creation of a stand-alone BCC. According to the NCCF, the BCC would be charged with the promulgation and enforcement of

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[60] Cite and provide formal title
[61] *See* NCCF Report, *supra* at 58.

consumer protection laws, but also to monitor and promote competition and inclusion for the benefit of consumers.[62]

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. Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal.[63]

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."[64] Among the benefits of the federal charter identified by the NCCF was the ability to override 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.

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[62] *See* NCCF Report, *supra* note, at 59.
[63] NCCF Report, *supra* at 4.
[64] NCCR Report, *supra* note, at 59.

The idea of a federal regulatory body charged with a consumer protection mission is thus not novel. Notably, the NCCF's first choice was the creation of a general federal consumer financial protection agency that contained a dedicated BCC within it.[65] In contrast to the NCCF's proposed BCC, however, the CFPB is charged with a consumer protection mission, but does not have a formal mission to promote competition and inclusion. Among the Taskforce's recommendations is a recommendation that the CFPB's mission be formally modified to include competition as part of its charge.

On the other hand, the scope of authority and resources dedicated to the CFPB are novel. The CFPB's rulemaking authority is far broader than prior agencies held, notably the FTC. In the period 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.[66] 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 the Congressional Review Act), and new 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, as opposed to its traditional focus on disclosure regulation.

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[65] This resembles proposals that would have done what Congress did with 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 Abbott and Todd J. Zywicki cite heritage article

[66] cite

Dodd-Frank and the CFPB also added new 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. But enforcement, supervision, and regulation were patchwork affairs and often led to inconsistency and incoherence in consumer financial protection law. 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 substitutes for one another.[67] 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.[68]

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. The acquisition of supervisory authority to for the specific purpose

[67] 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 Clarke and Todd J. Zywicki, cite

[68] The CFPB held a symposium in 2019 to consider the definition of the term "abusive" and issued a policy statement in fall 2019 that provides a definition of the term. Cite, cite. 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 it as binding on its authority.

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 bureau exercises supervision not only traditional depository institutions (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 operations and powers designed to 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 entities of the federal government. These tools include: (1) Enforcement, (2) Supervision, (3) Rulemaking, (4) Education, and (5) Research.

This chapter of the Report analyzes what has been learned about consumer protection over time with a particular focus on consumer financial protection. 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.

III. 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, they can not only reduce access to products for consumers but actually result in *greater* harm to consumers by enabling unscrupulous providers to exploit vulnerable consumers through monopoly power or by driving consumers into the black market. Second, 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, sounds consumer financial policy is organized around four elements: (1) competition; (2) 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 consumer protection as conventionally defined.

Although these elements of consumer protection will be considered separately for analytical purposes, it should be evident that they are intertwined in practice. The link between information and competition, for example, is obvious. Less obvious, but equally important, is the relationship between consumer protection goals on one hand and the goals of competition and inclusion on the other and even the promotion of consumer protection goals itself. In particular, while consumer protection policy can be an effective tool for making markets work better and protecting vulnerable consumers, if designed poorly it can restrict access to quality products in a competitive marketplace and even drive desperate consumers out of mainstream and organized markets to turn to products and providers that could increase the overall harm to consumers from fraud and oppressive practices.

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, financial services, providers, and as a result, the overall economy. Fraudulent, deceptive, and 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. Moreover, absent assurances that they will not be taken advantage of by overreaching financial services providers, consumers will be reluctant to use financial products, including electronic payments and credit, thereby foregoing the economic gains from doing so.

This dynamic can be illustrated by the example of debt collection practices and their regulation, which also happened to be the primary concern of the NCCF with respect to consumer protection.[69] The economics of debt collection and creditors' remedies is straightforward.[70] With respect to the supply of credit, creditors will be unwilling to lend if they are unable to reliably collect their debts.[71] 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 have an overall effect of increasing the price and reducing the quantity supplied of credit. *Ceteris paribus*, creditors will seek access to the full panoply of remedies at their disposal and will seek to use those that provide the highest return in terms of reduced losses at the lowest cost.

On the demand side, however, in deciding whether to borrow, consumers will consider the costs associated with the possibility of delinquency and default in addition to the nominal price of the loan (such as the interest rate) consumers will also consider the cost of potential default. Harsher and more immediate remedies will be more costly to consumers than others. Thus, *ceteris paribus*, consumers will prefer strict limits on creditors' remedies. Limiting remedies, therefore, will shift out the demand curve for

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[69] *See* NCCF Report, *supra* note, at Chapter 3.

[70] This discussion draws from Todd J. Zywicki, *The Economics of Debt Collection and Its Regulation*, __ LOYOLA CONSUMER L. J. __ (201_). Cite

[71] 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 Kronman, *Contract Law In the State of Nature*, cite

consumer credit, as consumers will be more willing to borrow and take on credit where the consequences of delinquency and default are less costly.[72]

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.[73] 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:

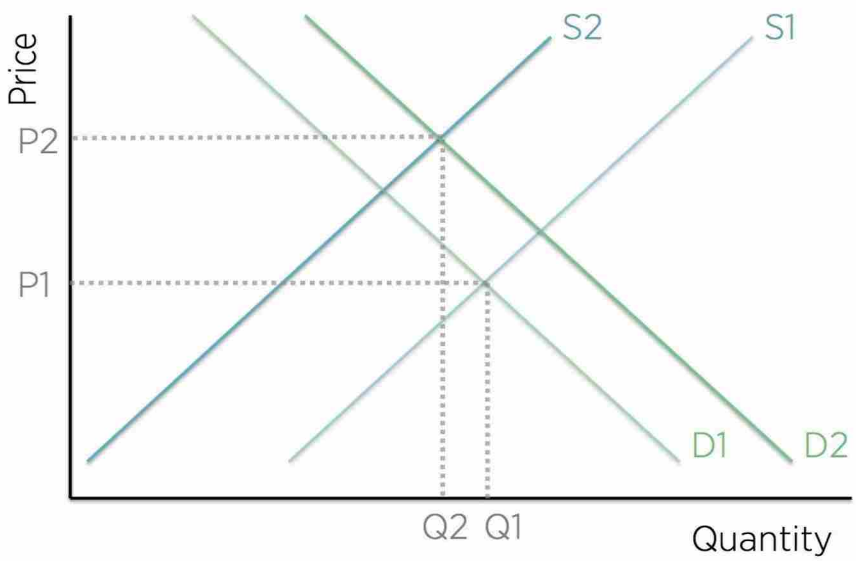

Figure 6-1 illustrates an inefficient restriction on creditors' remedies that reduces the equilibrium quantity of credit. Although consumer demand shifts out from D1 to D2,

[72] 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.
[73] Zywicki, *Creditors Remedies*, *supra* note, at __.

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. 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.[74]

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 were little-used by creditors for precisely this reason.

Regulation will have distributional effects in addition to efficiency effects. As noted above, usury regulations have been justified as beneficial for low-income consumers. In fact, usury regulations invariably injure the poor the most. Inefficient restrictions on creditors' remedies also end up hurting lower-income consumers more than higher-income.[75] Inefficient regulations increase the costs of collecting while also reducing the efficacy of collection measures, thereby reducing the returns per dollar

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[74] *See* Todd J. Zywicki, *The CFPB Could Be a Force for Good*, WALL ST. J. cite
[75] *See* Zywicki, *Debt Collection*, *supra* note, at __.

invested. As a result, restrictions on creditors' remedies will increase the risk and cost of lending to all potential borrowers but will increase the risk to riskier consumers the most. *Ex post*, riskier consumers would benefit most from restrictions on collection activities. But *ex ante*, these same consumers are those who are most likely to be harmed from limits on creditors' remedies. Regulatory limits will lead to compensating adjustments by lenders, most notably raising lending standards and rationing lending to riskier consumers, but also higher interest rates, larger downpayments, and shorter maturities (resulting in higher monthly payment obligations).[76] Lower-income consumers will have greater difficult coming up with liquid funds for a higher downpayment or meeting higher monthly payment obligations than will higher-income consumers.[77] 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.[78] As a result, lenders will also raise their minimum loan size to an amount that is economically feasible to collect.[79] Higher minimum loan size will exclude low-income borrowers that could have qualified for a smaller loan but are unable to be underwritten at a larger loan size. Overall, therefore, although restrictions on creditors'

[76] *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).

[77] 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, at __; *see also* Richard M. Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168 (2002).

[78] 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.

[79] *See* Dunkelberg, *supra* note, at 9.

remedies benefit those borrowers who do not pay their obligations, those benefits are funded largely by other lower-income consumers who pay higher interest rates and gain less access to credit.[80]

Much of modern debate over the scope and substance of consumer financial regulation rests on an implicit assumption that regulation must be zero-sum in nature, i.e., that regulation rests on a zero-sum 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 unanimously rejects this construct. Instead, the Taskforce recognizes the crucial role played by well-designed consumer protection rules, regulations, and other tools, 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.

B. The Role of Consumer Financial Protection Regulatory Agencies

[80] *See* Zywicki, *Debt Collection*, *supra* note, at __. In fact, as noted during the discussion of usury regulations above, by reducing the supply of credit made available to higher-risk borrowers, regulation can lead to a redistribution of capital to markets that serve lower-risks, which creates a regressive subsidy from lower-income to higher-income consumers.

The institutional framework of consumer protection, including consumer financial protection, has been described through the analogy of a "three-legged stool."[81] As then-Acting CFPB Deputy Director Brian Johnson explained the 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.[82]

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."[83] The third leg of the stool in the US is public agencies, which can help the other legs work better, such as by creating a framework that enables market competition to work better.

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 and consumer welfare generally. 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. This threat of punishment for businesses that do

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[81] *See* 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/"]); *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 was borrowed from Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. OF L. & POL. 393, 400 (2001).
[82] Johnson, *supra* note.
[83] Beales & Muris, *supra* note, at 2163.

not satisfy their customers can provide a powerful check on opportunism and low quality.[84] 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.[85] 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.[86] 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

[84] *See* L. G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980); Klein & Leffler cite
[85] Cite Tylenol, crisis in the cockpit,
[86] The role of advertising in the competitive process is discussed extensively in Chapter 7.

by two percentage points, increasing passenger loads by 10%, and $2 *billion* in incremental annual revue.[87]

The importance of competition and responsiveness to consumer demand applies to the consumer financial services industry as well. 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.[88] Survey research conducted by the Federal Reserve supports this strategy. Ninety-two percent of consumers report that they "can easily get a credit card from another company if they are not treated well."[89]

Given this high degree of competition and ease with which consumers can abandon providers that mistreat them, it is not surprising that consumers, in general, 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.[90]

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,[91] and banks will find it far less expensive in the long run to keep a loyal customer satisfied than to fight over a few

[87] *See* Geoffrey Manne & Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, __ J. L. ECON. & POL'Y __ (20__).
[88] CFPB ARBITRATION STUDY cite
[89] Canner & Elliehausen (2013) cite; *see also* Durkin 2000 "credit card use" cite
[90] Canner & Elliehausen, *supra* note, at __.
[91] *See* discussion in Chapter 7, *infra*.

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 usually results in the bank voluntarily issuing a refund. Examining the reports of one medium-sized regional bank, for example, Johnston and Zywicki found that overall 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.[92]

The importance of treating customers fairly is illustrated by the public response to the infamous Wells Fargo "fake account" scandal that came to light in 2016.[93] 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 has lost an estimated $220 billion in market capitalization as a result of the fake account scandal and market and regulatory responses to it.[94]

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[92] *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).
[93] *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"].
[94] *See* Hannah Levitt, *Wells Fargo Has Lost $220 Billion in Market Value Under Fed Cap*, BLOOMBERG.COM (May 15, 2020), *available in* [HYPERLINK

In the end, the number of customers that abandoned Wells Fargo in the wake of the scandal might have been less than predicted, in large part because competition among providers of basic bank account services is less robust than among credit cards, prepaid cards, or other financial services. Bank accounts tend to be "sticky" for consumers in a manner that most other products and services are not. The Taskforce addresses the question of how to better promote competition among providers of bank account services and how to reduce this problem of "stickiness" in Chapter 8, which focuses on competition in the market for consumer financial services.

Websites such as Yelp and Google enable consumers to testify directly to their experiences with various providers and products. Social media platforms such as Facebook and Google can quickly amplify the reputational harm to a company that mistreats its customers.

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. 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 Nerwallet.com. Purported market "failures," therefore, lead to market "solutions" as a result of consumer demand and the competitive process. Information about those products and services is useful to consumers and creates

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

a profit 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

Market forces such as name brands, reputation and repeat dealing thus can provide substantial protection for consumers. On the other hand, there are limits to the ability of market forces to optimally protect consumers from fraud and other market failures. Common law rights and remedies—namely contracts, property, and tort—can provide a mechanism for consumers to vindicate their rights in situations in which sellers "cheat" notwithstanding the reputation and other costs associated with doing so.

Legal enforcement of contractual promises and protection against fraud supplement the competitive process in providing consumer protection to consumers. 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 might be 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 to resolve consumer disputes can 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 and 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.[95] 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.

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.[96] 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,

[95] *See* Johnston & Zywicki, *supra* note.
[96] *See* Jason Johnston, No Harm Class actions, cit

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 harm to consumers from it.

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 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 common law is unable to do so. By preventing fraud and other harms to consumers, public agencies can help insure that the competitive process is fair and efficient for consumers. Moreover, as this Report discusses elsewhere, the Taskforce recommends that that CFPB's formal mandate be reformed to expressly recognize a dual mission of competition and consumer protection and to expressly consider the impact on the competitive process from proposed regulations and other actions.[97]

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 provided highly nuanced and personalized product and service attributes to individuals or small groups of consumers. Similarly, common law rests on the rights and remedies of 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.

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[97] *See* Chapter 8; Recommendations

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.[98] 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.[99] Although agencies can collect data and other types of evidence, this data 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.[100] 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 business people who use their vehicle (van or pickup truck, for example) as a source of short-term business finance.[101]

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 day on Wednesday. A handyman or painter might similarly pledge their vehicle to access short-term cash to purchase 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

[98] *See* MAXWELL STEARNS, TODD J. ZYWICKI, AND THOMAS MICELLI, LAW AND ECONOMICS: PRIVATE AND PUBLIC __ (discussing characteristics of agency decision-making).
[99] Mufarrige and Zywicki (forthcoming)
[100] *See* F.A. Hayek, *The Use of Knowledge in Society*, __ AM. ECON. REV. __ (date) cite
[101] *See* Hawkins cite, Zywicki cite

degree of certainty, and with minimal interest charges. To the regulator, however, this individual might appear to be an individual caught in a so-called "debt trap" who repeatedly borrows. The lender and customer, by contrast, are more likely to know the real purpose of the transactions and why they are not problematic.

Another example is that of consumer usage of overdraft protection.[102] 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 an emergency*, such as if their car breaks down in the middle of the night, a large majority of consumers say that they would. 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.[103] Moreover, when confronted with the exact same choice in the exact same situation, different individuals might make different choices. For example, 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.[104] 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.

[102] *See* Zywicki (or Smith and Zywicki?), cite
[103] THOMAS SOWELL, KNOWLEDGE AND DECISIONS cite;
[104] Todd J. Zywicki, *A Unanimity-Reinforcing Model of Efficiency in the Common Law*, __ CASE WESTERN L. REV. __ cite (discussing subjective value); JAMES M. BUCHANAN, COST AND CHOICE cite

A second danger with agency action and government regulation is the problem of incentives, both from external interest-group pressures as well as agencies themselves. 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 AG's will invariably 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. In addition, the attorney general will also have her own personal agenda that she desires to promote while in office. 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.

Federal agencies face different external and internal political influences from state attorneys general. Executive agencies technically report to the President, who is directly 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.[105]

But agencies are also subject to internal political influences. 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 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.[106] 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.[107] 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.[108] Moreover, those who head agencies might have future elective political ambitions themselves, which could influence their decision-making while running the agency.[109] In general, the greater the independent and insulation of agencies from political oversight and control the greater the opportunities of those within the agency to shape it according to their own goals and vision rather than those of the democratically-accountable branches.[110]

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[105] Weingast and Moran, cite
[106] Stearns, Zywicki, & Micelli, *supra* note,
[107] *See* WILLIAM NISKANEN, THE POLITICS OF BUREAUCRACY cite
[108] *See* Timothy J. Muris, JPE reponse to weingast and moran; Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, __ GEO. WASH. L. REV. __ cite
[109] For example, the first two government officials who headed the CFPB during its set-up and initial operation subsequently ran for elective office.
[110] This is a phenomenon known as "agency drift" Epstein cite

Overall, the lesson is crucial to remember—just as "market failure" predictably can occur, so can "political failure."[111] 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.[112] 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.[113] In addition, there is another category of consumer interactions that plainly have the potential to produce market failure for consumers: namely, those in which the consumers is 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, those

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[111] James M. Buchanan, *Market Failure and Political Failure*, 8(1) CATO J. 1 (1988).
[112] 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.").
[113] An additional alleged source of market failure relates to "behavioral economics," the claim that consumers suffer from predictable cognitive biases that produces welfare-reducing choices by consumers. That topic is discussed extensively in Chapter 3. The discussion here focuses on traditional economic claims about market failure that potentially justify government intervention.

three industries are consistently ranked among the top source of consumer complaints in the CFPB's Consumer Complaint database.[114]

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 an 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 aggressiveness in debt collection efforts that will enable creditors to collect debts efficiently while protecting consumers from overreaching practices.

Empowering delinquent consumers to choose their own debt collectors would be unlikely to produce an optimal level of firmness in debt collection. 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 forgiving. This would enable them to avoid repaying their obligations and to externalize some of that cost on to other consumers. 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 "harsh" toward the borrower.

But while this symmetrical conclusion is intuitively tempting, it is not necessarily correct. A creditor that collects its own debt might not be excessively aggressive under certain circumstances. In particular, where the debtor stands in a repeat-dealing

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[114] Cite complaint database reports

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, which would support aggressive collection measures, against a countervailing pressure to retain the customer as a future customer. In that instance, the retailer might be more passive than otherwise would be optimal.[115] And, consistent with that idea, data collected by the NCCF found that retailers carried unpaid customer balances longer than other creditors such as banks and finance companies.[116] 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.

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 not become creditors in the first instance. Retailers can sell goods to consumers, which they prefer to do, and outsource the unpleasant interactions and animosity of trying to collect delinquent debt. But third-party debt collectors help to address this incentive problem 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.[117] Third party collectors can thus be expected to be more

[115] *See* Zywicki, *Economics of Debt Collection*,
[116] *Id.*
[117] Zywicki, *Debt Collection*, *supra* note.

aggressive than originating creditors in collecting debts, which might bring loss rates closer to the optimal rate.

But lenders are not likely to escape not all of those consequences. 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 issuing entity, at least in part. This means that indirectly the originator of the debt does stand in an ongoing or repeat-dealing relationship with the consumer. This suggests that even though the consumer 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.

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 largely unregulated 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 remedies. In general the remedies that creditors preserved where those that were seen as both most effective by creditors at collecting the and also most fair by consumers. Moreover, creditors actually invoked only a subset of those remedies in practice. In short, creditors relied 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.

On the other hand, some creditors did insist on access to all remedies upon default and might have actually pursued those in practice. Many of the laws and regulations enacted at the state and federal level during that period effectively standardized the industry by outlawing some of these more arcane and unexpected terms.[118] 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.

This example suggests that even in markets where markets seem ineffective at protecting consumers, consumers may nevertheless be protected to at least some degree. Thus, although it is often implied that non-contractual markets must fail to protect consumers and that government regulation is therefore necessary, 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 forces in that market that indirectly protect consumers. Regulation can thus play an important role in supplementing markets.

Credit reporting agencies are similar 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

[118] Cite Zywicki *Debt Collection* and sources therein

information, to credit bureaus. But the selective reporting of only positive information would dramatically reduce the information content of credit bureaus.

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 little incentive 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. But challenging inaccuracies in one's credit report is time-consuming and can be aggravating, and many consumers may not know how to pursue a correction.

On the other hand, the agencies themselves have a strong incentive to make their records as accurate as possible as doing so will increase their value to those who purchase their services. Nevertheless, even though this to some extent aligns the incentives of the credit bureau with that of the consumer, it is an imperfect alignment. As a result, public agencies can play a role in crafting and implementing rules on credit rating agencies.

These examples illustrate how, 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.

IV. 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 by 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 the like. 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 the incentives created by understanding those incentives.

Consider the example of "rational default" on consumer loans Multiple factors influence whether a consumer defaults on her mortgage including, most obvious, macroeconomic conditions 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 is rationally responding to incentives to default instead of paying the debt. The concept of rational default is straightforward. Consider a consumer's decision regarding a standard 30-year mortgage.[119] 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 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 the asset. 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 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. 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 sell 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

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[119] *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"].

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.[120] For example, homeowners are less likely to default in areas of faster home price appreciation than in otherwise-similar areas with slower appreciation.[121] 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.[122]

Consumers are also be more likely to exercise their option to default when the benefits of doing increase.[123] 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

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[120] 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).

[121] 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) (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, (Ctr. for Responsible Lending, Durham, N.C.), Dec. 2006, at 1, 13.

[122] "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. **Cite** 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. **Cite**

[123] *See* Zywicki and Okloski, *supra* note.

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 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).[124] 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 valuable to those with greater wealth to protect.[125]

The theory of rational default, however, is not limited to mortgages but also applies to other consumer financial products. Consider payday loans. Payday loans have been noted for their high rate of "rollovers," which occurs 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.[126] This assumption that for some reason consumers are forced to roll over their debt grounds the theory that for some consumers payday loans constitute a "debt trap" that they are unable to escape.[127] According to the CFPB's 2017 Small-Dollar Loan Rulemaking, the underlying cause of a borrower getting into a purported "debt trap" is

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[124] *See* Lawrence D. Jones, Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans, 36 J. L. & ECON. 115, 135 (1993).
[125] Cite study from California on antideficiency laws and foreclosure
[126] *See* 2017 CFPB Payday Loan Rulemaking
[127] *Id.*

the consumer's lack of sufficient income to repay the amount borrowed when due. As a result, in 2017 the CFPB issued a rule-making that required small-dollar lenders to establish the ability of the consumer to repay the amount borrowed according to an underwriting standard mandated by the CFPB.

But as the discussion of rational default indicates, it is not 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 defaulting but also of *not* defaulting. 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 instead of defaulting. But the Rule provides no support for this contention. Indeed, it admits that payday lenders rarely sue delinquent customers and rarely report them to credit bureaus. The CFPB also speculates that perhaps borrowers do not default because of fear of debt collectors, but it provides little beyond speculation to support the contention of aggressive debt collection practices by payday lenders. Even more to the point, even if debt collection practices are somewhat aggressive, they must be sufficiently aggressive that they deter a borrower from defaulting in the first place. Thus, all three potential threats that supposedly lead borrowers to roll over instead of defaulting, are largely unsubstantiated at this point. In short, at first glance it appears that the costs of default on a payday loan are actually quite small.

Moreover, default rates on payday loans are high. A large number of defaults occur before a borrower even makes her initial payment. This suggests that there are a large number of payday loan customers who are not deterred from defaulting and do not feel like they are somehow "trapped" in a debt they are "forced" to pay. Instead, this group of consumers plainly believes that the cost of default is smaller than the cost of not defaulting.

Why do payday loan borrowers roll over their loans when the cost of default appears to be low and, in fact, many borrowers do eventually default? One possible explanation is that these consumers turn to payday loans because they have limited credit options available to them. 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. If it is the case that payday loan customers choose not to default in order to preserve the benefit of future access to payday loans, then it is difficult to see this choice as creating a "trap" that the borrower cannot escape. Nor is it clear how imposing an ability-to-repay rule that would have the effect of prohibiting the borrower from acquiring the desired product would further a coherent consumer protection goal.

As this extended example of rational default indicates, before the CFPB chooses to intervene it must first establish that there is even a market failure attributable to a consumer protection problem. As suggested by the example of rational default on residential mortgages, many foreclosures resulted from consumers' rational responses to the incentives to default on mortgages that were underwater. When consumers are informed about the costs and benefits of making a choice and rationally respond to incentives, consumer protection regulators should be cautious about characterizing that situation as a consumer protection problem.

The Taskforce has been able to locate no evidence on why many consumers do not default on their payday loans and instead choose to roll over their loans. 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. Alternatively, the decision whether to roll over a payday loan might reflect a rational decision that the benefits of retaining the option of keeping the loan balance outstanding for another term exceed the costs of doing so. 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.

Correctly identifying the source of certain behaviors is crucial not only for properly identifying the nature of the purported consumer protection problem but also to avoid unintended consequences. Most important, if a certain state of affairs is explained by consumers' responses to incentives instead of consumer protection-type issues, then treating it as a consumer protection issue could actually exacerbate the problems. For example, as noted, the presence of antideficiency laws for residential mortgages in some states contributed to the severity of the 2008 foreclosure crisis by providing incentives for homeowners to default on their mortgages when home prices fell. Yet Section __ of Dodd-Frank provides specific statutory protections to ensure that more homeowners preserve their antideficiency rights under state law where relevant. As a result, this provision would almost certainly have the effect of *increasing* foreclosures during a future financial crisis. Although this might be justified on some other grounds, it is peculiar that legislation designed to stabilize the financial system and reduce the severity of future crises contains this provision that would exacerbate matters instead.

B. Market Failure and Government Intervention

When should government agencies intervene in the market to attempt to correct perceived market failures?

As an initial matter, it is important to remember that not every decision by a consumer necessarily reflects a market failure that raises a consumer protection issue. As will be discussed

Standard analysis suggests a three step analysis:

1. Is there a market failure?

2. Is there a feasible solution that could 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. The final section of this Chapter will discuss regulatory tools and how regulators can choose among the various tools available to them to intervene in the market to generate the largest benefit at the smallest cost.

1. Identify The Nature of the Market Failure

First, the nature of the market failure must be identified accurately in order to propose a useful remedy. In the world of consumer financial protection, this question often takes the form of asking whether the market failure is one of imperfect or asymmetric information—and thus subject to an information remedy—or instead some substantive problem that requires substantive regulation. Usury ceilings illustrate the difference between these two predicates. Usury laws provide an example. As discussed above, traditional consumer financial protection regulation at the state level 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.[128] 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.

As discussed above, beginning in the 1970s, consumer financial protection began to migrate away from substantive regulation that supplanted consumer choice and mandated regulatory-imposed product design, toward information and disclosure-based regulation designed to help facilitate competition and consumer choice. This new approach made markets and consumers the primary architects of product design instead of government regulators. As noted above, this evolution in regulatory strategy arose in

[128] 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. *See* discussion *supra* at ____ and accompanying text.

response to the growing consensus that substantive regulation, as exemplified by usury ceilings, was ineffective at best at protecting consumers, because of the ease of circumvention. Indeed, in most instances, usury and other similar regulations were viewed as pernicious and harmful to consumers.

This growth in economic understanding was 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 were seen as less-able to manage their finances than men, a stereotype that rested on the longstanding assumption that women had poor math skills and that aggressive retailers would goad them into unnecessary purchases and heavy debt.[129] 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 racial stereotyping as well.[130] 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 imply the reality that there are certain groups of consumers who are indeed vulnerable cognitively or in some other fashion, such elderly Americans who suffer from cognitive decline as they age or others who are unable to protect themselves. But in a free society and economy, there is a presumption that consumers are autonomous actors who typically know better than governmental central planners what challenges and opportunities they face and how to best meet their needs

[129] Lendol Calder cite including page cite
[130] Cite economic sociologist article from alan schwartz's article

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 only be remedied by replacing the outcome of consumer choice and competition with government mandate.

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

Second, the government remedy must be responsive to the market failure that is identified. 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 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, providing additional information might actually be counterproductive from the perspective of the consumer, social welfare, or both. 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.[131] In turn, this information can lead consumers to make inferior choices than they would have without the additional information.

Trying to use disclosure and information-forcing rules to accomplish substantive ends could also be counterproductive by failing to accomplish the desired substantive goal but also undermining the goals of disclosure-based regulation of providing information valued by consumers. This tactic of mandating disclosure of terms that regulators believe consumers should care about has been called "normative" disclosure.[132] These disclosures can be seen as an effort to modify consumer behavior in particular ways preferred by regulators, not to simply take those preferences as given and facilitate their satisfaction, as is the goal of traditional disclosure regulation.

Given the presence of a market failure, these two approaches to regulation have been labeled "market-reinforcing" and "market-replacing" regulation.[133] 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

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[131] *See* discussion in Chapter 7.
[132] *See* Todd J. Zywicki, *The Market for Information and Credit Card Regulation*, __ BANKING AND FIN. SERVS. REPORT __ (cite)
[133] *See* Todd J. Zywicki, *Market-Reinforcing versus Market-Replacing Consumer Finance Regulation*, *in* REFRAMING FINANCIAL REGULATION: ENHANCING STABILITY AND PROTECTING CONSUMERS __ (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 the two approaches to regulaton).

themselves and their families."[134] 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.[135]

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."[136] 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."[137]

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

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[134] Zywicki, *Market-Reinforcing*, *supra* note, at 321.
[135] Johnson, *Deputy Director Johnson's Speech*, *supra* note.
[136] Zywicki, *Market-Reinforcing*, at 320-21.
[137] Zywicki, *Market-Replacing*, *supra* note, 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* Brian Johnson, *Toward a 21st Century Approach to Consumer Protection* (Nov. 15, 2018) (speech delivered to Consumer Action), *available in* [HYPERLINK "https://www.consumerfinance.gov/about-us/newsroom/toward-21st-century-approach-consumer-protection/"].

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. Potential costs of intervention should include not only direct costs, such as increases in costs that will be passed through to consumers as higher prices, but also costs resulting from decreased choice, innovation, and competition. This Report returns to this theme in chapter 13 in discussing the application of cost-benefit analysis to interventions. A few words are in order here, however.

As discussed above, the first unintended consequence of regulation of consumer financial products is term repricing. For example, the imposition of usury ceilings leads to predictable offsetting price adjustments, such as requiring higher downpayments for loans, higher bank fees for depositors, the imposition annual fees for credit cards, or stricter terms for default and collections. Any estimate of the costs associated with a regulatory intervention should take these offsetting factors into account. Moreover, as a matter of standard economic theory, the new set of regulatory-induced terms will be presumptively more expensive or otherwise less-preferred than the terms for which the parties would have voluntarily contracted. For example, as discussed above, stricter usury ceilings tend also to be associated with stricter default and collection terms, as issuers are more aggressive at pursuing collections from delinquent borrowers in order to reduce loss rates. It is by no means obvious that this new package of terms—lower interest rates but more aggressive collections—is preferred by consumers *or* providers than the alternative that the market would provide, even leaving aside the costs of the predictable credit rationing effects for higher-risk and lower-income consumers that are a byproduct of usury ceilings.

As discussed above and in Chapter 5, one effect of regulatory intervention is product substitution. 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 pawn shops. In addition, as discussed in Chapter 5, demand for these products tends to be relatively inelastic and 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.

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, as noted above, one important effect of 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, 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.[138] 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.[139] 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.[140]

Finally, a full accounting of costs should include the costs associated with rationing access to credit. Some of these costs, such as the historical depredations caused by loan sharks and illegal lenders that prey on vulnerable families, are difficult to quantify but 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. Traditionally, regulators have

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[138] *See* discussion *supra* at notes __-__ and accompanying text. As noted above, in states with binding usury ceilings on auto loans, auto dealers also originate a higher percentage of loans than in less heavily-regulated states and increase vehicle prices and reduce trade-in allowances to offset their inability to charge market rates of interest. *See* discussion *supra* at notes __-__ and accompanying text.

[139] Once an annual fee is paid, it is a capital investment for the consumer that will be sacrificed if the consumer stops using the card before the year is up. Notably, most ordinary credit cards today do not require payment of annual fee. Those that do, such as rewards cards, frequently waive or provide a reduced annual fee for the first year in order to induce consumers to switch to the card.

[140] *See* Diego Zuluaga, England payday loan rule

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). Market-replacing rules, in general, can be expected to have higher costs than market-reinforcing rules. This is because, by definition, market replacing rules foreclose consumers from 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 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, 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.

Type I versus type II errors—costs of steering clear

V. Regulatory Tools

A final challenge for a regulatory agency is the appropriate use of their regulatory tools. When the agency decides that there is 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 empowered by Dodd-Frank, CFPB has five distinct sets of tools: (1) Regulation, (2) Enforcement, (3) Supervision, (4) Education, and (5) Research. 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 Few regulatory consumer protection regulatory agencies possess such a wide variety of tools. The FTC, for example, lacks the supervision authority that the CFPB possesses and also lacks 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.

This unique combination of five tools in one 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 the designated regulatory task. On the other hand, possessing several tools that could all be brought to bear on the same question raises the danger of duplicative an inconsistent regulation by different offices within the same regulatory agency. This danger, in turn, highlights the need for diligence and persistence in insuring that various offices wielding different tools 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 has been for 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 implementation of 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.[141] For example, the definition of "abusive acts or practices" applied the 2017 Small-Dollar Loan Rulemaking shows little similarity to the CFPB's use of the term in its enforcement actions.[142] With respect to exercise of its supervisory authority, the CFPB had provided very little information about how the term would be applied in that context, largely simply restating the language of Dodd-Frank with no additional

[141] 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"].

[142] *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"].

elaboration.[143] 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 mandates that are simply inconsistent or which pile on multiple demands that together generate costs that outweigh the benefits of regulation. Notably, because is was issued only a policy statement and not pursuant to Notice and Comment rulemaking procedures, the policy statement applied only to the enforcement and supervision divisions of the CFPB and not to the Small-Dollar rulemaking, thus the potential inconsistent definitions across the CFPB's divisions could still persist.

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 the job. Examples are provided below. Although the Taskforce wants to make clear it is not endorsing these criticisms in practice, they illustrate the potential costs of using ill-fitting tools.

A. Regulation

Regulation is arguably the most extensive and far-reaching power possessed by the CFPB. Dodd-Frank specifically mandated that the CFPB issue rules on particular subjects. **Provide some examples and citations** The CFPB is also prohibited from issuing any rule imposing an interest-rate ceiling.[144] Beyond that, 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

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[143] *Id.*
[144] Cite

and practices.[145] To date, the CFPB has issued __ major rules. Of those, __ were rulemakings required by Congress and __ have been discretionary rulemakings.[146]

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 the decide how to most appropriately implement them. 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. Rules-based regulation, by contrast, is highly prescriptive and typically provides not only detailed outcomes but detailed means to accomplish them as well. The long, detailed prescriptive menu of mandatory disclosures, both in content and format, required by TILA, RESPA, and other similar regulations exemplify rules-based regulation. As the example of prohibiting "unfair" acts and 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 intellectual crossroads. Consumer protection policy in the United States traditionally has been largely principles-based, as CFPB's UDAAP power was largely inherited from the FTC. By contrast, federal banking and financial services regulation traditionally has tended to be more rules-based and prescriptive, as exemplified by the prudential regulators.

CFPB's status as both a financial regulator and consumer protection regulator presents the challenge of integrating these two disparate approaches into a coherent

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145 Cite
146 Cite and get relevant info

regulatory approach. This challenge is exacerbated by the diversity of the industries that CFPB regulates. Banks and credit unions traditionally have been regulated primarily in 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 unfairness and deception. Because it regulates both types of institutions, the CFPB 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 run 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.[147] Rules-based regulation also requires

[147] 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).

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.

The difficulty with rules-based regulation is illustrated by the long and winding path of the regulations under the Truth-In-Lending Act.[148] **elaborate**

On the other hand, principles-based regulation can create anxiety and uncertainty for the regulated community. 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 sort of 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 socially valuable activities. This could be especially counterproductive if those most impacted by the deterrent effect created by regulatory uncertainty are higher-risk consumers who are often those who would benefit the most as well. This tradeoff regarding uncertainty 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.[149] 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-based regulation (as opposed to rules-based regulation) can result in conflicting regulatory interpretations emanating from different

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[148] *See* Durkin & Elliehausen, TILA book (cite)
[149] *See* Frank Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984).

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.

The CFPB has in some instances engaged in rulemakings that contain highly 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 the specific underwriting and ability to repay model that they essentially were required to use to make that determination.[150] A principles-based regulation, by contrast, would have permitted the regulated parties greater flexibility to apply their own underwriting model to reach the desired goal.[151] This decision to mandate not just an 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—

[150] *See* 2017 Small Dollar Loan Rule. 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.
[151] 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.

have weakened. Moreover, even if rules-based regulation increases predictability in the short-run, the constant need for updating those rules in response to external technological and social changes increases unpredictability across time.[152]

The sentiment of the Taskforce is that 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, producing cost and uncertainty. 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.

At the same time, the Taskforce recognizes that by 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. 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

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[152] *See* BRUNO LEONI, FREEDOM AND THE LAW (cite) 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 or Menace?*, *supra* note, at __.

Opinion program designed to increase the predictability of the CFPB's regulatory posture.[153] 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.[154] In January 2020, the CFPB issued a policy statement "Regarding Prohibition on Abusive Acts or Practices."[155]

An additional potential mechanism for reducing uncertainty would be greater use of regulatory "safe harbors." Although Taskforce recognizes the value of safe harbors in theory, we also express some wariness about their use in practice. It is difficult to define the scope of a safe harbor in a principles-based fashion instead of an ad hoc pragmatic carve-out. Moreover, just as rules-based regulation itself tends to produce obsolescence and difficulty to change, rules-based safe harbors can have the same effect. Once a safe harbor is created, it can be difficult to modify as circumstances change as favored interest groups will have an incentive to lobby for its protection. 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 expresses wariness of that approach as a general strategy.

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B. Enforcement

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[153] 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"].

[154] Cite

[155] *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"].

The CFPB's second primary tool is enforcement. Enforcement serves two functions for a regulatory agency. First, it is an important tool in itself to deter wrongdoing and provide recompense for injured consumers. Second, it is an important tool to support regulation, especially principles-based regulation. Under this second approach, principles-based regulation outlines an abstract regulatory framework and then yields to enforcement to illuminate how those principles apply in particular contexts and to particular fact situations. Enforcement can also be an important tool for updating regulatory principles and applying those principles to new situations and technologies, and to protect consumers from new and emergent threats.

Enforcement, however, should not be used as a substitute for rulemaking and thereby to establish new substantive rules for an entire industry or to change a pattern of practice across an entire industry. Just as regulation should be somewhat in abstract and should not try to anticipate and regulate every single detail and contingency that could arise under a rule's potential application, 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.

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 to protections to consumers provided by cost-benefit analysis and makes it difficult to consider and measure the full range of unintended consequences that flow from the regulatory mandate.

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.[156] By their nature, consent agreements provide only limited and largely one-sided information regarding the factual underpinnings of a case. 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 to be illegal behavior, unlike an adjudication before a judge, consent agreements not provide any precedent or information about what is *not* illegal behavior. One practice adopted by some agencies to provide guidance as to

[156] *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).

questionable behaviors that will not incur liability is to publish "Closing Letters," announcing the termination of an investigation without any allegation of illegality.[157]

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.[158] 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 also provides internal guidance to the CFPB's enforcement attorneys to identify priorities

[157] *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"].
[158] *See* CFPB Policy Statement on Abusive Acts and Practices, *supra* at __ (summarizing testimony and conclusions of CFPB).

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.[159] 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 additional guidance on Advisory Opinions, No-Action Letters, and other guidance regarding its enforcement protocols and priorities.

Similar principles of preventing 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 beneficial behavior, therefore, remedies should be predictable and should be grounded in consumer harm.[160] 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 unsuccessfully prosecuted.[161] 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.[162] In reading many CFPB enforcement cases, it is not always evident how the CFPB arrived at the damages it seeks

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[159] *See* Statement of Todd J. Zywicki, Abusive Acts and Practices, *supra* note, at __.
[160] *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"].
[161] *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).
[162] *See* Cooper and Kobayashi, *supra* note.

in particular cases or the degree to which the damages sought are grounded in consumer harm.

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 difficult 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, provide a public matrix of the remedies they will pursue for certain violations. Although those matrices are not binding, 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

A third tool possessed by the CFPB to carry out its mission is supervision. Granted to the CFPB under in Dodd-Frank,[163] the CFPB's authority to engage in supervision is unusual for a consumer protection agency. Indeed, it might be unique—the Taskforce is unaware of any other consumer protection enforcement agency in the world that uses supervision as part of the advancement of its regulatory mission. 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.

[163] See 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).

Dodd-Frank's rationale for providing CFPB with supervisory authority is unclear. Moreover, the supervisory authority is unrelated to the rationale for the traditional supervisory authority over banks by prudential regulators. Exercise of supervisory authority over banks is a by-product of the special legal status of banks, arising from the Federal Deposit Insurance Corporation. The availability of deposit insurance to protect small creditors of the bank (depositors) is well-known to give 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.

The rationale for providing supervision as a tool for consumer protection is unclear, however. The traditional reason for providing supervision authority to bank regulators arises from the moral hazard problem and the largely unobservable risk of excessive risk-taking that arises from the presence of deposit insurance. By contrast, consumer protection deals with observable harms to third-parties, although not always easy or costless to detect. It is thus not clear why the CFPB has been granted supervisory authority and, as a result, it is also not clear how exactly the CFPB should exercise its supervisory authority. The purpose of this 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 and the like. At the same time, the supervisory process imposes 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 __ hundred employees around the country. 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.

This absence of a clear purpose for the CFPB's supervisory power is reflected in the CFPB's rulemakings regarding "larger market participants." It is not obvious what criteria the CFPB uses in to determine what constitutes a "larger market participant" across markets. In some instances the test focuses on the firm's financial receipts and in other situations the criteria is primarily the number of accounts they service.[164] Even where the same criteria is used to identify a larger participant, such as receipts of revenues, the amount varies from one market to another.[165] 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 applying supervision.

The scope of the larger participant exception is, of course, a rulemaking and not directly a matter of supervision. Still, the debate over the scope of the larger participant

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[164] *Compare* Defining Larger Participants of the Consumer Debt Collection Market, 77 FR 65775, 12 CFR 1090 (Oct. 31, 2012) ("larger participants" are those with over $10 million in receipts, excluding medical debts) *with* Defining Large Participants of the Student Loan Servicing Market, 78 FR 73383, 12 CF 1090 (Dec. 6, 2013) ("larger participants" are those with more than 1 million active accounts),
[165] 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 FR 42873, 12 CFR 1090 (Sept. 30, 2012).

exception illustrates the deeper ambiguity over the role played by supervision in the CFPB's tools. The respective roles of rulemaking and enforcement are, or could be, relatively clearly defined. It is not clear how the CFPB's supervisory authority relates to rulemaking and enforcement. In light of the substantial cost incurred by entities subjected to supervision, especially with respect to those firms that are close the lowest threshold, the CFPB should consider clarifying its goals with respect to exercising its supervisory authority. Better clarifying the purposes it seeks to accomplish through the exercise of supervision will enable the CFPB to more efficiently use this tool in a complementary fashion with its other tools and to ensure efficient and optimal consumer protection.

D. Education

Consumer education and financial literacy can be a powerful tool for empowering consumers to improve their financial well-being and more efficiently identify 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.

But informed and educated consumers also provide external benefits to *other* less-informed consumers by rewarding high-quality providers that offer fair products and treat their customers well 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. Less-educated consumers can thus free ride on the investment in consumers make in becoming more informed and acting on that knowledge. Moreover, *poorly* educated consumers 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 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 exert a negative impact on the value of neighboring properties. 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.

Thus, consumer education, like 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 consumer education 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. Informed 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. More informed consumers are also less likely to be duped 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 regime. 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.[166] 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 in complementing out regulatory 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

[166] *See* discussion in Chapter 7, *infra*.

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 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.[167] As former FTC Chairman William Kovacic has noted, the label takes its 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.'"[168] 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

[167] *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).
[168] Kovacic, *supra* note [NOTEREF _Ref44101945 \h], at 862.

validity of a hypothesis that can be later relied upon in assessing the wisdom of a proposed policy intervention.[169] 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."[170] 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 in recent decades.

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 establishment of an independent office of cost-benefit analysis to perform a cost-benefit analysis of substantive rules, or at least to review the cost-benefit analysis performed by the research team attached to a particular rulemaking procedure. 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, it is precisely because enforcement actions do not inherently have any such analysis of tradeoffs as part of its process —unlike rulemaking, in which policy R&D and cost-benefit analysis are 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.

[169] *Id.* at 865.
[170] FEDERAL TRADE COMMISSION, THE FEDERAL TRADE COMMISSION AT 100: INTO OUR 2ND CENTURY, THE CONTINUING PURSUIT OF BETTER PRACTICES at p. xiii (Jan. 2009).

Of particular importance in strengthening the CFPB's policy R&D functionality is its important series of Symposia on various topics that it convened during 2019.[171] 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 CFPB could 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.[172] 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. The CFPB's can be particularly 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

[171] *See* list various symposia on abusiveness, behavioral economics, small-business data collection, others? cite

[172] *See* FEDERAL TRADE COMMISSION, *supra* note [NOTEREF _Ref44104139 \h], 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).

explain why facially reasonable ideas could have adverse unintended consequences for consumers.