A potential contender to Fair Isaac developed an alternative to the FICO Score more than a decade ago but has failed to gain share. Litigation over its efforts to enter the market has uncovered evidence of barriers erected by Fair Isaac. In 2006, the NCRAs formed a joint venture to introduce VantageScore, and offered it to key lenders at a reduced price to build momentum for the alternative to the FICO Score. Fair Isaac sued the joint venture and Experian that same year, alleging that the NCRAs had violated antitrust laws by forming it, that they had infringed its trademark by using a score that ranged from 300 to 850, and that Experian had falsely advertised its proprietary credit score by saying it was the "same type that lenders see." The litigation lasted five years, until the Eighth Circuit Court affirmed a summary judgment that the joint venture had not violated the antitrust laws by introducing VantageScore and had not infringed on the trademark. The Court also affirmed a jury verdict that Fair Isaac had obtained the trademark by deceiving the US Patent and Trademark Office.[193] As for the advertising, the court agreed that the advertising was not literally or implicitly false. "Consumers purchasing Experian's [proprietary score were] seeing a credit score of the "same type" that lenders see, namely a score indicative of how lenders would assess an individual's creditworthiness."[194]

The Eighth Circuit ruling did not dent the dominance of the FICO Score and did not end the legal disputes regarding Fair Isaac's business practices. In more recent litigation, customers of credit ratings alleged that Fair Isaac used exclusionary agreements in order to maintain a monopoly.[195] One federal district court has ruled that Fair Isaac's contracts prohibiting CRAs from selling ratings and penalizing customers for buying them were adequate to support allegations of illegal monopolization.[196] The court also held that VantageScore's ads—some similar to those at issue in the Experian case and others claiming superiority over FICO Scores—could not be expected to deceive consumers. In addition to the private litigation, the Antitrust Division of the Department of Justice has opened an investigation into "potential exclusionary conduct" on the part of Fair Isaac.[197]

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193 Fair Isaac Corporation, et al v. Experian Information Solutions, et al, 332 F.3d 1150 (8th Cir. 2011).

194 Id. at 17 [need F 3d page].

195 Peter Strozniak, *Credit Unions Sue FICO for Alleged Antitrust Violations,* CREDIT UNION TIMES (May 12, 2020) https://www.cutimes.com/2020/05/12/credit-unions-sue-fico-for-alleged-antitrust-violations/?slreturn=20201015230658#:~:text=Three%20credit%20unions%20are%20suing%20the%20Fair%20Isaac,which%20harmed%20businesses%20and%20led%20to%20higher%20prices; Holmes County Bank and Trust Company v. Fair Isaac Corporation, N.D. IL Case: 1:20-cv-03395, available at https://classactionsreporter.com/wp-content/uploads/Fair-Issac-FICO-Credit-Scores-Antitrust-Compl.pdf.

196 Fair Isaac Corporation v. Trans Union, LLC, 1:2017cv08318 - Document 97 (N.D. Ill. 2019).

197 Release, *FICO Statement Regarding Antitrust Investigation* (March 15, 2020), available at https://www.fico.com/en/newsroom/fico-statement-regarding-antitrust-investigation.

Government policy and actions have hindered entry into the credit rating business. The Federal Housing Finance Agency (FHFA), Fannie Mae, Freddie Mac, and the CFPB have favored the dominant supplier. Until recently, a prerequisite for selling a loan to a government-sponsored entity was a FICO Score, which gave Fair Isaac a virtual lock on mortgage markets and an implicit endorsement that would be difficult for potential entrants to overcome. Another obstacle facing the most likely entrants was the CFPB, which sued the NCRAs for making essentially the same advertising claims that the Eighth Circuit had ruled were neither literally or implicitly false in the Experian case.[198] Since the CFPB cases settled, the record does not reveal whether they would have met the same fate as Fair Isaac's rejected efforts to prevent the NCRAs from advertising the VantageScore. There can be little doubt, however, that the effect of the repeated challenges to the advertising of alternatives to FICO Scores discredited the competitors in the marketplace. Experian paid a $3 million penalty to the Bureau, a reputational disadvantage for any competitor seeking to challenge a monopolist.

More recently, the FHFA and GSEs have lowered a major impediment to entry in the credit rating business. The FHFA issued a final rule in 2019 that allows the GSEs to qualify other ratings supporting mortgages they purchase.[199] The process is now underway, but it is too soon to estimate the effects of the new policy. Decisions of the GSEs can influence lending beyond the mortgages they purchase, but a level playing field for credit rating services will depend on the resolution of disputes over other potential barriers that may favor the dominant provider. However, if the services in other markets (and the custom services provided by the suppliers in this market) are an indication, credit scoring has room for more than one methodology and more than one provider. Exclusionary agreements and advertising restraints, whether privately assumed or officially imposed, give cause for concern about competition in this service that is critical to consumer credit.

As the courts weigh the merits of competitive practices in the markets for credit information, the markets themselves face disruption from outside. Potential entrants from the technology sector are taking advantage of data from their own customer relationships. The Bank for International Settlements (BIS) sees preliminary indications that big-tech firms are threatening banks and CRAs:

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198 See, Consent Order, /Experian Holdings, Inc. et al. File No. 2017-CFPB-0012 at paragraph 16 (alleging this claim was deceptive "See the same type of information that lenders see see when assessing your credit....") *See* also, CFPB, *CFPB Orders TransUnion and Equifax to Pay for Deceiving Consumers in Marketing Credit Scores and Credit Products; Credit Reporting Companies Misstated the Cost and Usefulness of the Credit Scores and Products They Sold, Lured Consumers into Costly Recurring Payments* (Jan 03, 2017).

199 Federal Housing Finance Authority, Validation and Approval of Credit Score Models Final Rule (8/16/2019) available at https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Validation-and-Approval-of-Credit-Score-Models-Final-Rule.aspx.

[B]ig techs can have a competitive advantage over banks and serve firms and households that otherwise would remain unbanked. They do so by tapping different but relevant information through their digital platforms. For example, Ant Financial and MercadoLibre claim that their credit quality assessment and granting of loans typically involve more than 1,000 data series per loan applicant.

Recent BIS empirical research also suggests that big techs' credit scoring applied to small vendors outperforms models based on credit bureau ratings and traditional borrower characteristics. All this could represent a significant advance in financial inclusion and help improve firms' performance.[200]

Encouraging as it may be, there is little likelihood that these innovations will become acceptable alternatives to the current third-party credit reports and scores. Maintaining competition among the current providers will remain critical to consumers. Also important will be market conditions that allow providers to compete and encourage lenders to drive competition.

8.4.2 Loan Servicing

Loan servicing—communicating with borrowers, processing payments, and managing expenses related to a loan—is an important component of consumer credit. For loans that last months and years, these services define the relationship between the debtor and the creditor, even though in many cases, the institution that originates a loan does not remain the creditor and does not service it. Third parties are the companies most likely to service mortgages, and mortgages account for the largest portion of consumer debt. According to a review of trends in mortgage origination and servicing in the "FDIC Quarterly", nonbanks accounted for 42 percent of the loans that the top 25 servicers handled, up from 4 percent in 2008. The nonbank mortgage servicers gained their market share largely by purchasing the rights to service existing mortgages.[201]

The growth of third-party mortgage servicing is an illustration of the forces that cause markets to emerge and the benefits that competition delivers. Mortgages in 2019 cost about $150 per year to service, if they were performing according to their terms, while servicing a mortgage that was not performing cost about $2,000 per year.[202] These costs were $59 and $482, respectively,

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[200] BIS, *ANNUAL ECONOMIC REPORT 2019*, 65 (2019) (internal citations omitted), available at https://www.bis.org/publ/arpdf/ar2019e.htm..

[201] Shoemaker, *supra*, note 170.

[202] Michael Fratantoni, *WHY HAVE BANKS STEPPED BACK FROM MORTGAGE SERVICING?*, International Banker, September 2, 2020.

in 2008, rising to $181 and $2,386 at their peaks in 2015. Servicing costs are factored into the pricing of a loan, which means that inefficient servicing will add needless premiums to the fees or interest rates that consumers pay.

Behind the rising costs were new processes mandated by regulations and increased legal exposure created by litigation as disputes mounted over servicing performance. Banks were less efficient at managing the former and sought to avoid the risk of the latter. Nonbank servicers had efficiency advantages due to specialization and the use of technology. As the FDIC report put it, "The technical expertise and innovation of many nonbank servicers is said to have helped them to be leaders in customer experience and process efficiency. And nonbanks reportedly have lowered delinquency and default rates by using technology to educate borrowers, streamline processes, and make loan modification processes efficient and effective."[203] A significant advantage of an efficient market for mortgage servicing is that banks and smaller lenders remain in the origination market, sustaining competition there.

One respect in which loan servicing can differ from the constituent parts embedded in other complex products is that the quality of a servicer's performance becomes obvious quickly and reflects on the originator. That reflection is likely to affect the originator's business. A report by the Bureau found that borrowers' priorities in choosing a lender or broker included the relationship that the borrower expected to have with the lender.[204] More than half of the borrowers responding to the National Survey of Mortgage Originations indicated that a prior relationship and a local branch were important when picking a lender; nearly three-quarters of the consumers with small servicers said so. Given the importance of that relationships, it is no surprise that numerous ratings and assessments of servicers are available to lenders and consumers, from commercial sources like J.D. Power,[205] and from government-sponsored entities like Fannie Mae.[206] In a message for lenders, an article reporting the J.D. Power results relayed a consumer comment that captured the essence of the study: "Communicate.... The

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[203] Id. at 61 (citing Marshall Lux and Robert Greene, "What's Behind the Non-Bank Mortgage Boom?" Harvard Kennedy School, June 2015:5, https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/42_Nonbank_Boom_Lux_Greene.pdf.).

[204] CFPB, *Data Point: Servicer Size in the Mortgage Market,* (November 2019), available at https://files.consumerfinance.gov/f/documents/cfpb_2019-servicer-size-mortgage-market_report.

[205] See, e.g. J.D. Power, COVID-19 Pandemic Increases Customer Expectations of Mortgage Servicers, J.D. Power Finds, (July 30, 2020);

[206] Fannie Mae, *STAR Program 2020 Reference Guide,* Available at https://singlefamily.fanniemae.com/servicing/star-program.

customers that you are ignoring now will NOT be returning customers!"[207] An ad for the top-rated company appeared alongside the article. Creditors in need of better loan service than they can provide internally (or than they are getting from their current servicer) have options in the marketplace.

8.4.3 Debt Collection

The incentives for seeking efficiency and quality in loan servicing may be more attenuated when it comes to debt collection, since a lender may have less interest in preserving an ongoing relationship with a borrower who has been referred to a debt collector.[208] A Bureau survey published in 2017 found high proportions of consumers responding that debt collectors were using tactics that companies cultivating relationships would avoid, such as threatening consumers, calling consumers at inconvenient times and failing to honor requests to stop contacts. Avoiding such practices is also fundamental to compliance with debt-collection laws, but enforcement reports from both the Bureau and the FTC contain numerous cases of collectors that did not measure up to standards.

It is another question, however, whether competition can play a role in helping or hindering consumers' experiences and collectors' compliance with the law. On this issue, the evidence suggests that it can. Just as automakers have incentives to find the best quality parts at the best price, creditors have incentives to find debt collectors that are more likely to improve consumer experience, performance of loans, and legal compliance. The demand for improvements along these metrics is apparent in numerous reports and rankings of the "best" debt collection agencies[209] and in offers from experts and consultants proposing good business practices for the collection industry. A study commissioned by FICO, for example, concluded with this advice: "Institutions that are beginning to implement this more customer-centric approach—or at least

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[207] Clayton Jarvis, *Digging into J.D. Power's mortgage servicer satisfaction study,* MPA Mag, (August 3, 2020), available at https://www.mpamag.com/news/digging-into-j-d--powers-mortgage-servicer-satisfaction-study-229563.aspx.

[208] This theory is often cited in support of rules to prevent abusive collection tactics. See, e.g. CFPB, *Debt Collection Practices (Regulation F) Final Rule; Official Interpretation,* at 473 ("Consumers do not choose their debt collectors, and, as a result, debt collectors do not have the same incentives that creditors have to treat consumers fairly."), (footnote omitted). See generally, Zywicki, Todd J., *The Law and Economics of Consumer Debt Collection and Its Regulation* (September 9, 2015). George Mason Legal Studies Research Paper No. LS 15-17, George Mason Law & Economics Research Paper No. 15-33, Available at SSRN: https://ssrn.com/abstract=2658326 or http://dx.doi.org/10.2139/ssrn.2658326.

[209] See, e.g., Donna Fuscaldo, *The Best Collection Agency Services of 2021,* business.com (Dec 07, 2020), available at https://www.business.com/categories/best-collections-agency-services/.

beginning to plan for such an evolution—will be well positioned to reap the benefits of a continued customer relationship and more effective collections."[210]

The role of competition in achieving legal compliance is also apparent in the demands that creditors make of debt collectors. A Bureau study in 2016 reported that large agencies generated most of the activity in the sector, with the top 300 companies of the 4,000 taking around two-thirds of industry revenue.[211] Large creditors typically use large agencies, and often more than one at a time. These creditors shift accounts from one agency to another, limit the collection tactics that agencies can use, and frequently audit the agencies' performance. Smaller creditors, which use smaller agencies, were less likely to follow these practices. Collection agencies that do not comply are likely to lose business to their competitors. Evidence that the agencies take the competitive threat seriously comes from the existence of yet another market: the consultants and technology vendors that offer services to comply with legal obligations.[212]

In short, the incentives to enhance consumer satisfaction need not be obvious or immediate, and the objectives may be largely limited to legal compliance concerns, but effective competition in efficient markets can improve consumer protection.

8.4.4 Payment Services

In 1972, the most elementary financial transaction meant a trip to a teller. In that respect, the experience 50 years ago did not differ from the beginning of the 20th century (except that for most consumers in the first half century, the teller would have been in an institution other than commercial bank). Today, consumers no longer need to travel to a bank, a branch, or even an ATM to access sophisticated financial services. According to the American Bankers Association,[213] 70 percent of U.S. consumers used a mobile device to manage their bank account at least once in September 2019, and a third of U.S. adults used a mobile app to make a payment or transfer money in the year. More often than not, the app they chose did not come from their

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[210] Aite Group, *Beyond the Call Center: Emerging Strategies for Collecting Consumer Debt*, (March 2019), at 21, available at https://www.fico.com/sites/default/files/2019-05/20190301%20FICO%20debt%20collection%20white%20paper%20FINAL.pdf.

[211] CFPB, *Study of third-party debt collection operations*, (July 2016), available at https://files.consumerfinance.gov/f/documents/20160727_cfpb_Third_Party_Debt_Collection_Operations_Study.pdf

[212] See, e.g. Experian, *Fair Debt Collection Practices Act (FDCPA) and Large Debt Collection Participants*, available at https://www.experian.com/regulatory-compliance/consumer-information/fdcpa-and-large-debt-collection-participants.

[213] American Bankers Association, *Survey 95 Percent of Consumers Give High Marks to Digital Banking*, (November 13, 2019), available at https://www.aba.com/about-us/press-room/press-releases/Survey-95-Percent-of-Consumers-Give-High-Marks-to-Digital-Banking

bank. Payment volume on PayPal and Venmo outpaced activity on the banks' apps. Apple Pay and Starbucks were also well established as alternative payment providers. The advent of these technologies is allowing a new type of bank to enter the market, a bank without physical retail locations. One survey estimated that 30 percent of the US population either has opened or plans to open an account at an online-only bank.[214]

Competition authorities and experts have examined payment systems and expressed concern that the markets have not kept up with the demands of consumers. The Organisation for Economic Co-operation and Development (OECD), for example, published the results of a 2012 roundtable on competition and payment systems.[215] The assembly saw need for improvement but was uncertain about how to proceed:

The ongoing shift from cash and paper towards electronic payment systems potentially brings large economic benefits. But card payments in particular have remained expensive for merchants, and regulation may have unintended consequences. There is no consensus among economists and policymakers on what constitutes an efficient fee structure for card-based payments, and it is not clear if payment competition might do the trick. Regulation should be geared towards removing barriers of entry in payment markets and banning merchant (pricing) restrictions. The discussion reviewed recent countries' experiences on developments regarding all non-paper-based forms of payment such as debit and credit cards, and E-payments (through internet, mobile phones etc.). Many members are investigating these markets, and EU jurisdictions are implementing the EU payments service directive, which aims to provide a single market for payments.

Some of those investigations had already resulted in numerous enforcement actions and a wide array of judicial decisions. In the United States, credit cards were found to constitute relevant markets for the payment services they provide in 2001, when a court held that Visa and Mastercard had restrained competition with contracts that excluded card issuers such as Discover and American Express from those markets, and ordered an end to the exclusion.[216] In

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[214] Liz Knueven, *Online banking isn't just for millennials anymore — it's quickly becoming the norm*, BUSINESS INSIDER (Nov 14, 2019), available at https://www.businessinsider.com/personal-finance/online-banking-gaining-popularity-united-states.

[215] OECD POLICY ROUNDTABLES, COMPETITION AND PAYMENT SYSTEMS (2012) available at http://www.oecd.org/competition/PaymentSystems2012.pdf

[216] United States v. Visa USA, Inc., 163 F. Supp. 2d 322 (S.D.N.Y. 2001) ("The proof demonstrates that [Visa and Mastercard] do weaken competition and harm consumers by: (1) limiting output of [rival] cards in the United States; (2) restricting the competitive strength of [rivals] by restraining their merchant acceptance levels and their ability to develop and distribute new features such as smart cards; (3) effectively foreclosing [rivals] from competing to issue off-line debit cards..., and (4) depriving consumers of the ability to obtain credit cards [with] different qualities, characteristics, features, and reputations.).

2004, retailers brought a class action to recover allegedly excessive swipe fees from Visa, Mastercard, and affiliated banks. The class and the defendants settled last year for $5.5 billion, although some retailers opted out to pursue separate relief.[217]

As the retailers' case was pending, the Department of Justice brought another case against Visa and Mastercard, as well as one against American Express. The government alleged that the companies had prevented merchants "from rewarding consumers when they use less expensive credit cards to make a purchase," and inhibited "merchants' ability to reduce card acceptance costs, and therefore their retail prices to consumers."[218] Visa and MasterCard settled, agreeing to allow merchants to offer rebates and discounted products and services to induce consumers to use other networks, lower-cost cards, or other forms of payment. American Express, however, chose to litigate, and its practice of preventing merchants from steering consumers to credit cards with lower fees was held to be a legitimate form of competition by the Supreme Court, which reasoned that although Amex's business model may have increased prices to consumers, it had "spurred robust interbrand competition," among networks had "increased the quality and quantity of credit-card transactions," and had not prevented Visa, MasterCard, or Discover "from competing against Amex by offering lower merchant fees or promoting their broader merchant acceptance."[219] The growth of credit card usage influenced the decision, as did the shares of the major players. Visa, Mastercard, and Discover were accepted at 50 percent more locations and together processed nearly three times Amex's transaction volume. Four justices dissented, reasoning that transaction platforms could violate the antitrust laws if buyers alone suffered adverse effects.[220]

While contentions over the practices of payment platforms generate debate, the growth of rival payment systems indicates that innovation in payment systems could change the markets dramatically. The evidence from mobile payments shows how quickly new methods can catch on. When banks in Singapore introduced a new mobile payment technology, researchers found:

In the first year subsequent to the QR code introduction, the number of consumers who signed up (used) mobile payment increased by 53.8 percent (304 percent). The average monthly

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[217] *See* Generally, *Payment Card Interchange Fee Settlement Official Court-Authorized Settlement Website*, https://www.paymentcardsettlement.com/en/Home/FAQ#faq7.

[218] Department of Justice, Justice Department Sues American Express, Mastercard and Visa to Eliminate Rules Restricting Price Competition; Reaches Settlement with Visa and Mastercard (October 4, 2010), https://www.justice.gov/opa/pr/justice-department-sues-american-express-mastercard-and-visa-eliminate-rules-restricting.

[219] Ohio v. American Express Co., 585 U.S. ___,_ (2018) (The state of Ohio was also a party.)

[220] Id. (Breyer, J. dissenting.)

growth rate of mobile payment's share of total consumer spending also rose from 7.1% in the year before the technology shock to 21.1% in the year after.[221]

Innovations in payment systems are coming from outside the banking sector as well. Consumer banking services have attracted interest from leading tech companies such as Facebook and Google. Facebook has been exploring the establishment of a global financial system with a new crypto currency,[222] while Google is reportedly planning new checking account offerings, in partnership with banks, according to "Business Insider."[223] Google sees advantages in the customer bases that banks have, as well as in their experience "navigating the regulatory complexities of the banking sector."

If the regulatory challenges can be overcome, BIS sees significant competition coming from the technology sector:

> Big techs' low-cost structure business can easily be scaled up to provide basic financial services, especially in places where a large part of the population remains unbanked. Using big data and analysis of the network structure in their established platforms, big techs can assess the riskiness of borrowers, reducing the need for collateral to assure repayment. As such, big techs stand to enhance the efficiency of financial services provision, promote financial inclusion and allow associated gains in economic activity.[224]

Echoing an objective of the Bureau, BIS advised regulators to ensure a level playing field between big techs and banks. The potential for competition to translate innovation and efficiency into access and inclusion is clear.

An example of the transformative potential of new entry comes from China, where Ant Group, a digital payment platform, has become a major lender of short-term debt. According to "The Wall Street Journal," "In the span of a year, Ant Group Co. originated loans to half a billion people in China and accounted for nearly a fifth of the country's outstanding short-term consumer debt as

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[221] Sumit Agarwal, Wenlan Qian, Yuan Ren, Hsin-Tien Tsai, and Bernard Yeung, *The Real Impact of FinTech: Evidence from Mobile Payment Technology* (October 2020). Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3556340

[222] Mike Isaac and Nathaniel Popper, *Facebook Plans Global Financial System Based on Cryptocurrency*, NEW YORK TIMES, June 18, 2019, available at https://www.nytimes.com/2019/06/18/technology/facebook-cryptocurrency-libra.html.

[223] Gregory Magana, *Google is planning to break into banking with new checking account offerings,* BUSINESS INSIDER, Nov 14, 2019, https://www.businessinsider.com/google-will-begin-offering-checking-accounts-2019-11

[224] BIS (2019), *supra* note 200, at 55.

of June."[225] The company has enlisted 100 banks, from rural houses to national institutions, to originate the loans, although it holds some of the debt itself and sells some to investors. The information that Ant has gained from its users' payment activity has given it an advantage over the banks that rely on third-party credit reports and ratings. According to the "Journal," Ant's typical customer "has unmet consumption demand due to the lack of a credit card or insufficient credit limits .... Individuals born after 1990 make up half of the customers for nonbank consumer financing companies."[226] A national banker acknowledged to the "Journal" that banks do not have access to the information or the risk models that Ant has accumulated and developed to assess these borrowers. The competition spurred by Ant's entry into the market has given millions of consumers—credit invisibles and thin files—access to credit.

New forms of competition can be expected to prompt protests from incumbents and interests that support the status quo. Indeed, the sequel to Walmart's struggle to compete with banks has begun in the United States. Among the major players this time will likely be FinTech companies that did not exist when Walmart launched its first campaign. The reaction that the Square and Nelnet charters provoked and the resistance to allowing big tech near banking is unlikely to fade. Indeed, Ant's initial public offering has been postponed due to regulatory hesitation in China, and regulators in the states have opposed OCC's move to issue charters to FinTech companies that do not take deposits. The head of the Conference of State Bank Supervisors dismissed the argument advanced by OCC that businesses operating on a global scale should not need a license in every state in this country. State regulators counter that they can best "serve the interests of consumers, industry, and local economies." Local regulation, they argue, "gives consumers more control over their financial well-being, including the terms of credit offered in their communities."[227]

However FinTech companies will fare in their efforts to compete, it is too soon to count out the pioneers that saw consumer credit as the means to finance a new industry a century ago. According to a recent report, General Motors is considering the formation of an industrial bank that would accept deposits and make loans on electric automobiles.[228] The company that

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[225] Yang, Jack Ma's Ant Group Ramped Up Loans, Exposing Achilles' Heel of China's Banking System, WALL STREET JOURNAL, Dec. 6, 2020.

[226] Id. (internal quotations and references omitted). Whether Ant Group will be able to overcome regulatory resistance to its consumer lending remains to be seen. See, Xie Yu, *China Tells Ant Group to Refocus on Its Payments Business,* WALL STREET JOURNAL (Dec. 27, 2020).

[227] John Ryan, *Congress, not the OCC, decides what is and isn't a bank,* AMERICAN BANKER, August 19, 2020, https://www.americanbanker.com/opinion/congress-not-the-occ-decides-what-is-and-isnt-a-bank.

[228] Orla McCaffrey and Mike Colias, *GM Plans to Seek Banking Charter to Grow Auto-Lending Business,* WALL STREET JOURNAL, Nov. 27, 2020, available at https://www.wsj.com/articles/gm-plans-to-seek-banking-charter-to-grow-auto-lending-business-11606501125.

embraced consumer credit despite its social stigma and used it to overtake Ford as the largest automaker in the United States may once again engage consumers in the financing of an industrial revolution. This time the effort would underwrite the expensive technology that is displacing the internal combustion engine.

Whether fear of big tech proves to be a more formidable barrier than the social stigma of consumer credit in 1920 or the opposition to Walmart in recent times remains to be seen. So far, the 21st century has accrued a cautionary history of efforts by innovators to cross the borders of the banking sector.[229] Nonetheless, potential competitors keep trying. Consumers have much at stake in how the next chapter will unfold.

In short, there are signs of progress, but a history of failed attempts to offer banking services counsels caution along with optimism. The proportion of the population without a bank account remains significant. Payments are still dominated by bank cards. Whether these characteristics stem from indifference on the part of consumers or from barriers to competition for banking and payment services is worth continued examination.

8.5 Competition and Equal Access to Credit

With the ability to rank consumers, to decide whether and how much to lend, and to customize credit products, lenders can and do treat different consumers differently. When the exercise of that ability is limited to sound business reasons, like the risk that a loan will be repaid, the differences that result can enhance efficiency, consumer welfare, and system stability. Ignoring legitimate distinctions, on the other hand, can increase the incidence of debtor default and raise the cost of credit. In extreme cases—such as the Crash of 1929, the Savings and Loan Crisis of the 1980s, and the Global Financial Crisis of 2007-2008—inadequate attention to risk of repayment can compromise financial markets and threaten entire sectors of the economy.

History has documented centuries of harm that persecuted, excluded, and marginalized populations have suffered from credit discrimination that had little or nothing to do with legitimate distinctions. (Appendix B to this chapter describes some of the episodes.) The ECOA was enacted in 1974 to address serious discriminatory harms and prohibit the discrimination that inflicts them. Federal and state policies with discriminatory impacts have been and continue to be repealed and reformed. The ongoing efforts to protect consumers from prohibited

[229] Id. The article on General Motors recalled, "More than a decade ago, a wave of opposition led by the banking industry pushed retailers Walmart Inc. and Home Depot Inc. to abandon their attempts to secure industrial-loan charters."

discrimination is the subject of other chapters. This chapter explores some evidence whether competition can ameliorate the harm or contribute to that protection.

As a matter of theory, when buyers in a marketplace have numerous choices with whom to deal, they can penalize providers that engage in discriminatory actions by patronizing competitors that do not. As described in Chapter 10, studies of various industries have confirmed the theory with evidence that the discipline of competition does reduce discrimination. The empirical research tends to confirm the hypothesis that competition reduces discrimination in credit markets as well. In an extensive study of bank branches, Lux, et al., found that increasing competition benefits populations that have been disproportionately denied loans:

> [T]he effect of intensified bank competition is stronger for populations that are ex ante more likely to be rationed by banks, which reinforces the identification of supply effects. First, we find that black households benefit more from branching deregulations than do non-black households only in states with a history of discrimination. For the same level of income, black households are indeed 20% less likely than white households to hold a bank account in states with a history of discrimination, but this gap narrows to only 15% after deregulation, to the level observed in states with no history of discrimination. Second, the effect of branching deregulations increases when the level of income decreases.[230]

In mortgage markets, competition from the new wave of digital lending has taken business away from traditional sources and given more of that business to nontraditional customers. A recent "New York Times" article reported that "discrimination is falling, and this trend corresponds to the rise in competition among various lenders.[231] Similar trends appear in CFPB data, which show Black or African American and Hispanic shares of mortgages up 10 percent overall since 2010.[232] Borrowers interviewed for "The New York Times" article said they faced fewer obstacles applying for credit online than in person, and their experiences were consistent with the findings of a study conducted by a team of researchers at University of California at Berkeley, who found that FinTech companies discriminated less than face-to-face lenders.[233] In the study, discrimination declined between 2008-2009 and 2014-2015, a result that "could be due to competition from the platforms and/or the ease of shopping around made possible by online applications." Although the analysis could not prove causation, "the pattern seems to reflect

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[230] Marshall Lux and Robert Greene, *The State and Fate of Community Banking,* M-RCBG ASSOCIATE WORKING PAPER SERIES (February 9, 2015), available at https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf. (including a survey of the literature).

[231] Jennifer Miller, *A Bid to End Loan Bias,* New York Times, September 20, 2020, at Business 4.

[232] CFPB (2019), *supra* note 172.

[233] Bartlett, et al., Consumer-Lending Discrimination in the FinTech Era,

growing competition edging out the possibility" that loan officers were extracting discriminatory rates. The results also showed rejection rates were lower for FinTech than face-to-face loans and lower still for the lenders that relied more on FinTech. Discrimination among FinTech lenders was less than half that found among smaller traditional lenders.

Another study considered settings where competition may be attenuated and found that opportunities for discrimination increased. One situation that has been the subject of research and regulation is the market for automobile loans, many of which are made in a private negotiation in the dealership. A study of that sector found that competitive markets did not drive the lowest prices for consumers, because poor transparency in the market allowed dealers to create better deals for themselves than for consumers.[234] In these loans, according to the authors, credit worthiness of the individual borrower and the details of the auto loan (term length, payment-to-income ratio, etc.) significantly influenced price. The study also found, however, that prices paid by consumers varied widely even after controlling for credit worthiness, and minority borrowers paid more than their relative risk and other legitimate factors justified:

A majority of consumers paid no markup over the credit-based buy rate, while a small percentage of consumers paid thousands of dollars in additional markup. Moreover, minority borrowers were found to be highly overrepresented in the category of those paying significant markups.[235]

Chapter 9 explores how the market has responded to situations such as these, and how competition through innovation could protect future consumers. Chapter 10 evaluates regulatory efforts to improve inclusion.

8.6 Conclusion

The foregoing review of competitive conditions today finds evidence consistent with the circumstances described in the NCCF Report and with observations from historians who have studied the credit sector throughout its development. The most important dynamic of

[234] Cohen, Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation, REVIEW OF LAW AND ECONOMICS (2012).

[235] Id. A study of mortgages analyzed FHFA data for evidence of discrimination against minority borrowers relative to white borrowers in more concentrated markets. The results "fail to reject the null hypothesis of no noneconomic discrimination." James A. Berkovec, Glenn B. Canner, Stuart A. Gabriel and Timothy H. Hannan, *Discrimination, Competition, and Loan Performance in FHA Mortgage Lending*, REVIEW OF ECONOMICS AND STATISTICS, Volume 80, Issue 2, p.241-250 (May 1998), available at https://doi.org/10.1162/003465398557483).

competition—ease of entry—remains essentially free of intrinsic impediments in credit markets. The number of suppliers available to serve consumers' demand for credit, across a variety of credit products and services, far exceeds levels considered adequate for robust competition. There appears to be no intrinsic barrier to competition in lending.

Nonetheless, some sectors display worrisome symptoms of competitive impairments. Two sectors stand out. The first is the supply of small loans to borrowers with below-average credit qualifications—populations that are disproportionately poor, unbanked, and in great need. Consumers in this sector often resort to inferior options because better options are unavailable – sometimes because of the high costs of operating profitably in certain markets and sometimes due to barriers to entry into those markets. The second sector is the supply of information, particularly credit ratings and credit reports. To contemplate that competition among information providers to the sector might be less than robust is ironic, given the rapid advances in information technology over the past 50 years. Information is plentiful and cheap. Monopoly power in this sector would be especially disquieting given that information is indispensable to credit transactions. If information is more expensive, more restricted, or less accurate, it is likely to raise the cost and reduce the availability of loans and other financial services to consumers.

The impediments to competition in credit markets are not unique. Nor is the source of the problems. To the contrary, the problems and their provenance are commonplace in antitrust experience. Providers of financial services, like competitors in many industries, have attempted to insulate themselves from competition. Sometimes the insulation takes the form of exclusionary behavior by dominant firms. Sometimes competitors collectively develop standards and certifications that discourage entry. Tactics such as these can purchase protection for years, but seldom permanently. The most effective and durable barriers are those that become ossified in the amber of laws and regulations. In the case of credit, those barriers can take the form of enforceable interest-rate caps, licensing restrictions, territorial and product limitations, suppression of information, and outright prohibitions of competition.

The enforcement of the antitrust law is entrusted to other agencies, but the preservation of competition depends on more than the prevention of anticompetitive conduct. Within the Bureaus' powers are numerous tools to ensure "that markets for consumer financial products and services are fair, transparent, and competitive,"[236] and that "markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation."[237] These tools range from facilitating the free flow of accurate information to leveling the playing field for competitors regardless of their status as depository institutions. The

[236] DFA Section 1021(a) (12 U.S.C. § 5511(a))

[237] DFA Section 1021(b)(5) (12 U.S.C. § 5511(b)(5))

NCCF expressed aspirations fifty years ago that the federal government would lead in the harmonization of consumer credit laws to achieve similar purposes:

The effect of the present fractionalized legislation and regulation upon consumers should be reviewed as well as the progress of efforts to enact state consumer credit legislation. Enactment of consumer credit legislation of the type recommended in this report ... should be also reviewed to determine whether any added amendments inhibit the basic aim of ensuring free entry of firms and fair treatment of all consumers. Should this research demonstrate that the states are not fostering an environment in which consumers have access to a wide variety of competitive financial services, that progress of consumer credit legislation at the state level is too slow, and that overall Federal legislation is deemed infeasible, then the Commission recommends that Congress undertake federal chartering of finance companies in a manner designed to remedy these deficiencies in the market for consumer credit.[238]

Two and a half centuries of economic scholarship have refined the definitions and explanations of competition, but the appreciation of its role in the economy remains much the same as when Smith articulated it in 1776. Effective competition drives prices down to the costs of providing goods and services and incentivizes producers to reduce those costs more. It pushes sellers to find the best deal they can get and to offer the best deal they can give. It is, as the NCCF noted, painful for the participants on the selling side. But it is beneficial to everyone on the buying side, including consumers of financial services.

[238] NCCF, *supra* note 5 at 166.

CHAPTER 8, APPENDIX A:

Summary of Statutory References to Competition and Efficiency

The Dodd-Frank Act mentions "competition" in four places:

- Section 1021(a) (12 U.S.C. § 5511(a))—identifying the Bureau's statutory purposes, including to ensure "that markets for consumer financial products and services are fair, transparent, and competitive."
- Section 1021(b)(4) (12 U.S.C. § 5511(b)(4))—identifying five objectives for which the Bureau may exercise its authorities, including to ensure that "Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition."
- Section 1031(c) (12 U.S.C. § 5531(c))—stating that the Bureau may not declare an act or practice to be unfair unless it has a reasonable basis to conclude that the act or practice causes or is likely to cause substantial injury and that "such substantial injury is not outweighed by countervailing benefits to consumers or to competition."
- Section 1100(f)(2) (12 U.S.C. § 5107(f)(2))—identifying factors that the Bureau must consider when promulgating rules to implement the SAFE Act, including "the need to ensure a competitive origination market that maximizes consumer access to affordable and sustainable mortgage loans."

The Dodd-Frank Act mentions "efficient" markets, regulations, or enforcement in three places:

- Section 1021(b)(5) (12 U.S.C. § 5511(b)(5))—identifying five objectives for which the Bureau may exercise its authorities, including to ensure that "markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation."

- Section 1013(c) (12 U.S.C. § 5493(c))—identifying the functions of the Bureau's Office of Fair Lending and Equal Opportunity, which include "coordinating fair lending efforts of the Bureau with other Federal agencies and State regulators, as appropriate, to promote consistent, efficient, and effective enforcement of Federal fair lending laws."
- Section 1013(g)(3)(E) (12 U.S.C. § 5493(g)(3)(E))—identifying the duties of the Bureau's Office of Financial Protection for Older Americans, including to "coordinate consumer protection efforts of seniors with other Federal agencies and State regulators, as appropriate, to promote consistent, effective, and efficient enforcement."

At least three of the eighteen enumerated consumer laws identify ensuring competition or efficiency as among their purposes:

- FCRA section 602(a)(1)) (15 U.S.C. § 1681(a)(1))—listing Congressional findings, including that, "Inaccurate credit reports directly impair the efficiency of the banking system."
- FDCPA section 802(e) (15 U.S.C. § 1692(e))—identifying the FDCPA's purposes, including "to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged."
- TILA section 102(a) (15 U.S.C. § 1601(a))—listing Congressional findings, including that, "The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit."

By comparison, the FTC Act explicitly prohibits unfair methods of competition:

Section 5 (15 U.S.C. § 45)—prohibiting unfair methods of competition and empowering and directing the FTC to prevent persons from using unfair methods of competition.

Statutory Text

Below are the relevant statutory provisions from the Dodd-Frank Act, FCRA, FDCPA, TILA, and FTC Act.

Dodd-Frank Act

DFA section 1021 (12 U.S.C. § 5511). Purpose, objectives, and functions.

(a) Purpose. The Bureau shall seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.

(b) Objectives. The Bureau is authorized to exercise its authorities under Federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services—

(1) consumers are provided with timely and understandable information to make responsible decisions about financial transactions;

(2) consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;

(3) outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;

(4) Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and

(5) markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

DFA section 1031(c) (12 USC 5531(c)). Prohibiting unfair, deceptive, or abusive acts or practices.

. . .

(c) Unfairness.—

(1) In General. The Bureau shall have no authority under this section to declare an act or practice in connection with a transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service, to be unlawful on the grounds that such act or practice is unfair, unless the Bureau has a reasonable basis to conclude that—

(A) the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and

(B) such substantial injury is not outweighed by countervailing benefits to consumers or to competition.

(2) Consideration of Public Policies. In determining whether an act or practice is unfair, the Bureau may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

DFA section 1100 (12 U.S.C. § 5107). Bureau of Consumer Financial Protection backup authority to establish loan originator licensing system.

. . .

(f) Regulation Authority.—

(1) In General. The Bureau is authorized to promulgate regulations setting minimum net worth or surety bond requirements for residential mortgage loan originators and minimum requirements for recovery funds paid into by loan originators.

(2) Considerations. In issuing regulations under paragraph (1), the Bureau shall take into account the need to provide originators adequate incentives to originate affordable and sustainable mortgage loans, as well as the need to ensure a competitive origination market that maximizes consumer access to affordable and sustainable mortgage loans.

DFA section 1013 (12 U.S.C. § 5493). Administration.

. . .

(c) Office of Fair Lending and Equal Opportunity.—

(1) Establishment. The Director shall establish within the Bureau the Office of Fair Lending and Equal Opportunity.

(2) Functions. The Office of Fair Lending and Equal Opportunity shall have such powers and duties as the Director may delegate to the Office, including—

(A) providing oversight and enforcement of Federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for both individuals and communities that are enforced by the Bureau, including the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act;

(B) coordinating fair lending efforts of the Bureau with other Federal agencies and State regulators, as appropriate, to promote consistent, efficient, and effective enforcement of Federal fair lending laws;

(C) working with private industry, fair lending, civil rights, consumer and community advocates on the promotion of fair lending compliance and education; and

(D) providing annual reports to Congress on the efforts of the Bureau to fulfill its fair lending mandate.

. . .

(g) Office of Financial Protection for Older Americans.—

. . .

(3) Duties. The Office shall—

(A) develop goals for programs that provide seniors financial literacy and counseling, including programs that—

(i) help seniors recognize warning signs of unfair, deceptive, or abusive practices, protect themselves from such practices;

(ii) provide one-on-one financial counseling on issues including long-term savings and later-life economic security; and

(iii) provide personal consumer credit advocacy to respond to consumer problems caused by unfair, deceptive, or abusive practices;

(B) monitor certifications or designations of financial advisors who advise seniors and alert the Commission and State regulators of certifications or designations that are identified as unfair, deceptive, or abusive;

(C) not later than 18 months after the date of the establishment of the Office, submit to Congress and the Commission any legislative and regulatory recommendations on the best practices for—

(i) disseminating information regarding the legitimacy of certifications of financial advisers who advise seniors;

(ii) methods in which a senior can identify the financial advisor most appropriate for the senior's needs; and

(iii) methods in which a senior can verify a financial advisor's credentials;

(D) conduct research to identify best practices and effective methods, tools, technology and strategies to educate and counsel seniors about personal finance management with a focus on—

(i) protecting themselves from unfair, deceptive, and abusive practices;

(ii) long-term savings; and

(iii) planning for retirement and long-term care;

(E) coordinate consumer protection efforts of seniors with other Federal agencies and State regulators, as appropriate, to promote consistent, effective, and efficient enforcement; and

(F) work with community organizations, non-profit organizations, and other entities that are involved with educating or assisting seniors (including the National Education and Resource Center on Women and Retirement Planning).

Fair Credit Reporting Act

FCRA section 602 (15 U.S.C. § 1681). Congressional findings and statement of purpose.

(a) Accuracy and fairness of credit reporting. The Congress makes the following findings:

(1) The banking system is dependent upon fair and accurate credit reporting. Inaccurate credit reports directly impair the efficiency of the banking system, and unfair credit reporting methods undermine the public confidence which is essential to the continued functioning of the banking system.

(2) An elaborate mechanism has been developed for investigating and evaluating the credit worthiness, credit standing, credit capacity, character, and general reputation of consumers.

(3) Consumer reporting agencies have assumed a vital role in assembling and evaluating consumer credit and other information on consumers.

(4) There is a need to insure that consumer reporting agencies exercise their grave responsibilities with fairness, impartiality, and a respect for the consumer's right to privacy.

Fair Debt Collection Practices Act

FDCPA section 802 (15 U.S.C. § 1692). Congressional findings and declaration of purpose.

(a) Abusive practices. There is abundant evidence of the use of abusive, deceptive, and unfair debt collection practices by many debt collectors. Abusive debt collection practices contribute to the number of personal bankruptcies, to marital instability, to the loss of jobs, and to invasions of individual privacy.

(b) Inadequacy of laws. Existing laws and procedures for redressing these injuries are inadequate to protect consumers.

(c) Available non-abusive collection methods. Means other than misrepresentation or other abusive debt collection practices are available for the effective collection of debts.

(d) Interstate commerce. Abusive debt collection practices are carried on to a substantial extent in interstate commerce and through means and instrumentalities of such commerce. Even where abusive debt collection practices are purely intrastate in character, they nevertheless directly affect interstate commerce.

(e) Purposes. It is the purpose of this subchapter to eliminate abusive debt collection practices by debt collectors, to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged, and to promote consistent State action to protect consumers against debt collection abuses.

Truth In Lending Act

TILA section 102 (15 U.S.C. § 1601). Congressional findings and declaration of purpose.

(a) Informed use of credit. The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.

(b) Terms of personal property leases. The Congress also finds that there has been a recent trend toward leasing automobiles and other durable goods for consumer use as an alternative to installment credit sales and that these leases have been offered without adequate cost disclosures. It is the purpose of this subchapter to assure a meaningful disclosure of the terms of leases of personal property for personal, family, or household purposes so as to enable the lessee to compare more readily the various lease terms available to him, limit balloon payments in consumer leasing, enable comparison of lease terms with credit terms where appropriate, and to assure meaningful and accurate disclosures of lease terms in advertisements.

Federal Trade Commission Act

FTC Act section 5 (15 U.S.C. § 45). Unfair methods of competition unlawful; prevention by Commission.

(a) Declaration of unlawfulness; power to prohibit unfair practices; inapplicability to foreign trade.

(1) Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.

(2) The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations, except banks, savings and loan institutions described in section 57a(f)(3) of this title, Federal credit unions described in section 57a(f)(4) of this title, common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers subject to part A of subtitle VII of Title 49, and persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act, 1921, as amended [7 U.S.C. § 181 et seq.], except as provided in section 406(b) of said Act [7 U.S.C. § 227(b)], from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce.

(3) This subsection shall not apply to unfair methods of competition involving commerce with foreign nations (other than import commerce) unless—

(A) such methods of competition have a direct, substantial, and reasonably foreseeable effect—

(i) on commerce which is not commerce with foreign nations, or on import commerce with foreign nations; or

(ii) on export commerce with foreign nations, of a person engaged in such commerce in the United States; and

(B) such effect gives rise to a claim under the provisions of this subsection, other than this paragraph.

If this subsection applies to such methods of competition only because of the operation of subparagraph (A)(ii), this subsection shall apply to such conduct only for injury to export business in the United States.

(4)—

(A) For purposes of subsection (a) of this section, the term "unfair or deceptive acts or practices" includes such acts or practices involving foreign commerce that--

(i) cause or are likely to cause reasonably foreseeable injury within the United States; or

(ii) involve material conduct occurring within the United States.

(B) All remedies available to the Commission with respect to unfair and deceptive acts or practices shall be available for acts and practices described in this paragraph, including restitution to domestic or foreign victims.

* * *

CHAPTER 8, APPENDIX B:

A Brief History of Competition and Credit

There is little doubt that lending and borrowing have been integral to society throughout history. Medieval historian William Chester Jordan surveyed the literature and found, "Almost all the men and women who have studied so-called "primitive" societies...agree that life in those societies requires at least some use of credit."[239] In their History of Interest Rates, Homer and Sylla wrote, "Credit existed from the very earliest phases of economic activity, even before the evolution of barter proper."[240] By the Mesolithic and Neolithic Ages – from 8,000 BC through 5,000 BC and later, capital and credit became an important engine of human progress.[241]

Yet creditors seldom if ever play a leading role in historical accounts of ancient or great societies. Their masterpieces do not fill museums. Their biographies seldom climb bestseller lists. Great financiers do not bask in the acclaim that society accords to intellectual, cultural, and industrial giants. Medici, Morgan and Rothschild do not rank with DaVinci, Guttenberg and Edison. The heroes of consumer credit are even more obscure. Even among economic historians, until recently, the role of credit in consumers' lives has been a subtext at best. Economic histories measure growth by population, output, wealth, or life expectancy, seldom by the volume of credit or debt (except as an indicator of a country in trouble).

The irony in this oversight is that credit has precipitated, sustained, and rescued economic development since antiquity. Loans were matters of life or death for the first people who settled in the cradles of civilization. Credit was a medium of exchange before currency displaced barter and where coins were scarce. Credit – even consumer credit – financed exchequers and churches, crusades and wars. Lending created business opportunities for marginalized minorities and women, when many occupations were off limits to them. And perhaps most remarkably, credit – again, consumer credit – was the life blood of the economy in Colonial

[239] Jordan, Women And Credit In Pre-Industrial And Developing Societies, 12 (1993).

240 Sidney Homer, Richard Sylla, A History Of Interest Rates (2005) Kindle Edition, 772.

241 Id.

America. Without credit, the colonies would not have gained the audacity to demand independence or the wealth to fight the war for the future United States. And without credit, the country would not have grown as rapidly as it did. A bank loan financed the Louisiana Purchase, and countless consumer loans financed the settlement of the territories.

Recent scholarship has uncovered a great deal of information about the history of credit, and fifty years of data can now be added to the records available to the National Commission on Consumer Finance (Commission or NCCF) in 1972. The combination of these sources is a fortunate coincidence, as it allows us to update the case study in competition that appears in Chapter 8 of the Commission's report.

Credit was likely among the first economic activities in human history to evolve into meaningful competition, because all the elements of effective competition were abundant at the beginning of civilized society. First and foremost, for any good or service, competition depends on buyers and sellers finding a place and time to engage in commerce. The bigger the gathering, the more numerous the participants, the more effective competition will be. Since antiquity, people understood these concepts, and they sought the benefits that accrued from an abundance of choices. The word, "compete," stems from the Latin, *competere*, meaning to come together.[242] Buyers and sellers organized the gatherings where competition took place and called them markets, the name for which appears throughout ancient languages – the Old French *marchié* or *markiet*, the Old German markat, the Old Norse *markaðr*, the Latin *mercātus*.[243] There is little doubt that whatever was traded in the earliest markets, credit was one of the first businesses to reach the scale that could support competition in a market.

Markets of significance had to await the advent of agriculture, which allowed people to settle in permanent locations. Settlements became villages and created opportunities for specialization, such as the crafting of tools and milling of grains, which could support individuals who concentrated on the work. Smaller villages might support one crafter in each trade. If the sum of all customers' demands could not generate enough revenue to cover the costs of two vendors, then one would enjoy a natural monopoly. The sole potter or seamstress would know that the only alternative to their service was for customers to bake or sew themselves, which they could not do as efficiently as the specialist. The single shop could command a price well above what it cost the specialist to produce the goods. The price premium would be an invitation to others

[242] "Compete." Merriam-Webster.com Dictionary, Merriam-Webster, https://www.merriam-webster.com/dictionary/compete. Accessed 10 Jun. 2020.

[243] "Market." Merriam-Webster.com Dictionary, Merriam-Webster, https://www.merriam-webster.com/dictionary/compete. Accessed 10 Jun. 2020.

with skills in the trade to open another shop, if the village grew large enough, and the potter could find himself vying for customers who could buy a cheaper pot from a new shop.

Economic historian Peter Acton described these competitive dynamics in a vignette of a small village in ancient Greece.[244] Which trades became competitive most quickly depended on such factors as the expense of setting up dedicated operations, the rapidity with which they could reach efficient scale, the talent pool of local crafters, and the willingness of authorities to grant permits needed to open. Expensive investments can impede entry. So can occupational restrictions and social stigma. Low startup costs and tolerant authorities, on the other hand, facilitated entry. Of the familiar trades of antiquity, millers, tailors, bakers, butchers, and brewers multiplied quickly and congregated conveniently in merchant districts. For many merchants, shop-keeping was a part-time occupation, which helped lower costs. The butcher would continue to raise livestock, the tavern-keeper's family could still work the crops. Aspiring tanners, smelters and metal workers, on the other hand, who had more expensive equipment to buy and fewer places to locate due to the pollution they emitted, had to be more deliberate with their decisions to build facilities and dedicate their time.[245] The facilities and the real estate they occupied were expensive, even when idle. Competition in those trades likely emerged more slowly.

Like the growing settlements in ancient Greece, villages in the Middle Ages developed near the lord's manor or at crossroads and riverbanks in the country. As the villages grew, merchants multiplied and competition intensified. In larger towns, merchants of similar items sometimes clustered along common streets, which acquired names based on their trades – Millers Row, Baker Street, and the like. Towns accommodated an abundance of specialized labor, various trades, monetary exchanges, and "a concentration of diverse monumental buildings – large churches, bell towers, warehouses, permanent market halls, guild halls, hospitals and so on."[246] Larger towns, and cities that some became, also suffered some of the banes of modern urban life, like traffic jams, as carts delivering goods and criers carrying messages jostled through narrow streets.[247]

Rarely if ever, however, did a town grow large enough to accommodate enough commerce inside its walls or on its periphery to realize the full benefits of competition. Fortunately, the residents

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244 Acton, "Industry Structure and Income Opportunities in Ancient Athens," in The Ancient Greek Economy: Markets, Households and City-States, edited by Edward M. Harris, David M. Lewis, Mark Woolmer, 158 (2016); see also, Acton, Poiesis: Manufacturing in Classical Athens. New York: Oxford University Press, 2014.

245 Id.

246 Jordan, Europe in the High Middle Ages, 17 (2003).

247 Id.

did not have to wait for local stores to develop into competitive markets. Those came in the form of itinerant merchants who hauled their wares along the roads and rivers of Africa, Asia and Europe and visited villages and towns throughout the regions. Townsfolk welcomed them and designed their towns to accommodate them. In virtually every town, the most valuable real estate, near the very center, was left empty. There, at dawn on predetermined days, the open square filled with merchants displaying items from near and far. Itinerant merchants rented stalls next to local vendors hawking their own produce and goods. Buyers included consumers for themselves and merchants for retail customers. Vendors at the markets (and enclosed halls in larger towns) found themselves vying for customers who were conveniently comparison shopping. "Sellers of particular goods...were typically set next to each other in areas so that competition was kept high."[248] Prices in the market stalls often beat prices in the shops.[249] Consumers with limited options among the local stores suddenly had an abundance of choices, and they took advantage of it.[250] All converged in a frenzy of buying and selling. Then the itinerants departed for their next stop on the trade route, and the locals took their bargains home.

Competition was especially keen during annual and seasonal fairs, large events that drew merchants of all types, lasted for weeks, and offered entertainment and lodging for customers who would stay for days and stock up for a season. The fairs in Champagne, for example, drew throngs from great distances and became holiday destinations,[251] like state fairs that blossom annually at harvest season in many modern states. These grand fairs were popular with shoppers but tough on shopkeepers who stayed home to tend the store or bore the expenses of simultaneously running a local establishment and a stall at the fair. Some of the largest selections and best terms in the Middle Ages were available in the markets of Champagne.

The effects of extensive markets were nowhere more evident than in the great cities of the ancient civilizations. Competition thrived in ancient seaports, where ships could deliver cargoes from hundreds of miles away at relatively modest expense, and the overland journey to the outskirts was manageable. Voyages still took time and cargo holds filled quickly, which rendered ships unsuitable for the perishables in volumes that large populations consumed, but they were ideal for durable goods, the more valuable the better. As a result, early intercity trade comprised

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[248] Mark Cartwright, *Trade in Medieval Europe,* ANCIENT HISTORY ENCYCLOPEDIA, (08 January 2019), available at https://www.ancient.eu/article/1301/trade-in-medieval-europe/

[249] Clerici, L., "Le prix du bien commun. Taxation des prix et approvisionnement urbain (Vicence, XVIe-XVIIe siècle)" [The price of the common good. Official prices and urban provisioning in sixteenth and seventeenth century Vicenza] in I prezzi delle cose nell'età preindustriale /*The Prices of Things in Pre-Industrial Times,* [forthcoming], Firenze University Press, 2017

[250] Cartwright, *supra* note 10.

[251] Id.

plenty of precious metals, spices, and fabrics.[252] Transportation was key to competition, and financial assets were among the early beneficiaries.

At the peaks of the ancient civilizations, urban populations found much of life's needs in local markets. The estimated quarter-million people in Ancient Athens in the 4th century BC[253] had neither the space nor the time to sustain themselves on what they made and grew at home. Ancient Rome, which housed as many as half a million to a million in its heyday,[254] had a population density that rivals modern cities. When Romans went shopping, they had their pick of vendors – in storefronts, open air markets, and precursors of modern department stores – like the five-story Market of Trajan, which sold "fresh fish, herbs and spices, wine and oil and much more."[255] Competition in many of the consumables of daily life thrived for the city dwellers of antiquity. Thanks to that competition, they attained a standard of living that the world would not see again for almost a thousand years.[256]

The Dark Ages left few records, but there is little doubt it brought about a decline in competition along with the other indications of commercial activity. Urban life in France almost vanished after the fall of Rome, and with it went the burghers (the class comprising merchants), which dropped to an estimated 3 percent of the population in towns and cities in the heart of Europe in 600 AD.[257] At the turn of the first millennium, an estimated 90 percent of European population lived in the countryside, in or near villages and manors, and most people lived and died without straying more than twenty or thirty miles from the places of their birth. Country roads fell into disrepair. Pirates swarmed sea lanes and rivers. Travel became more dangerous and more expensive as traders had to bear the expense of extra protection or the risk of losing their entire inventories to bands of highwaymen. Markets shrank to a fraction of their former reach.

For competition to elevate economic life in the Middle Ages, it had to develop again, and it had to start where the people lived, in circumstances not much different from the small villages of earlier millennia. Farmers and villagers had to make do with homegrown food and homemade goods, supplemented by occasional purchases from the few crafters and merchants that

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[252] Cantor, The Civilization of the Middle Ages Ch. 26 (1994) (valuables attracted pirates and thieves, requiring itinerant merchants who traveled farther to endure greater risks and bear the expenses of greater security).

[253] Thorley, John, *Athenian Democracy* Lancaster Pamphlets in Ancient History, 74. (2005) ISBN 978-1-13-479335-8.

[254] Glenn Story, *The population of ancient Rome,* ANTIQUITY 71 (1997): 966-78.

[255] SHOPPING AND MARKETS IN ANCIENT ROME, available at https://www.historycrunch.com/shopping-and-markets-in-ancient-rome.html#/

[256] Cantor, *supra* note 14, Ch. 26.

[257] Id. Ch 11.

remained. Jordan describes the landscape of the tenth century. Towns were "few in number and very small in size."[258]

Gradually, and then with increasing speed, settlers gravitated back to the remnants of towns and villages that had flourished in the Empire. Villages grew, and towns multiplied exponentially in the first centuries of the second millennium AD. As Jordan describes the transformation,[259] over the next three hundred years, the "thinnest sprinkling" of settlements that might have been deemed urban grew to 1,500 by the mid-thirteenth century, and another 1,500 fifty years later.[260] The Rhineland, which had counted no more than eight towns in the 1100s, added fifty in a century. Competitive markets returned to the locations where they had once thrived. The proliferation of towns, many on the roads and waterways that had linked the Roman Empire, precipitated new flows of itinerant merchants. And the travelers of the Middle Ages had a technological advantage over the Romans. Halters and stirrups proliferated in the tenth and eleventh centuries, speeding transportation, shortening travel time between markets, and increasing the flow of goods. Itinerants were creating regional markets; cities were making them international.

Competition in credit depends on the same factors as competition in other goods and services, and fortunately for consumers in need of financing, the intrinsic barriers to functional credit markets are minimal. A lender faces fewer startup costs than almost any other merchant, whether the potter or innkeeper on a bustling street in a medieval village, or the small business of today. Turning raw materials into a loan requires no potter's wheel, no kiln, no bar, no kitchen, no guest rooms. In many cases, especially in primitive and emerging markets, credit does not even require extraordinary measures to protect inventory or proceeds. A credit transaction needs no currency. The extension and repayment of loans needs only an understanding that could be reflected in a written bill, a ledger entry, or an oral undertaking. Terms can be based on barter comparisons or cash proxies. Security can be an ordinary possession, pawned until repayment. The only valuables involved could be the goods delivered, the promise to repay the lender later, and the information that gave confidence in the promise.

Many concerns of public nuisance and safety do not arise in the business of creditors. Their trades do not pollute the air or water. They do not handle hazardous materials. Lending does not assault the ears of neighbors. Indeed, creditors could, and often did, conduct their business inconspicuously, without a store or stall for the purpose. Anyone who had the raw material –

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[258] Jordan, *supra* note 8, 17.

[259] Id.

[260] Id.

money or goods that they did not need at the moment – could become a creditor. The raw material was the finished product.

In primitive societies, however, specialized lenders were rare. Most farmers could not go to the local bank or lending company if a plow or halter broke down in the middle of planting season. They might have every reasonable prospect of a good harvest, once the crop was in the ground, but harvest was months away, and the household had family to feed and livestock to grow. Whatever savings the family had accumulated might not last from one harvest to the next. And farmers were not alone. Merchants could run short when their customers could not pay. But rent was a regular expense. At the mercy of the landlord, a merchant in arears had to borrow or surrender his shop, and with it his livelihood. If they could not borrow, as Jordan observed, the obvious alternative "might be starvation or death." [261]

Fortunately, borrowers had other options. Almost everyone was in position to be a lender or a borrower. Many were both, as most people are today. For the farmer, it might have been a blacksmith who could repair the plow and take payment later. For the merchant, the landlord could forbear for a rent cycle or two. Indeed, that is what happened, innumerable times. Lending became a lucrative sideline that traders, merchants, and landlords were able and eager to practice. Creditors came in many forms: shopkeepers, itinerant merchants, tavern keepers, notaries, monks, clerics skirting religious canons. Credit opened opportunities for groups that did not enjoy the full rights of citizens. Minorities facing prejudice could make a living (or at least supplement it) by lending. Jews often did. So did women. In the Middle Ages; alewives, pawnshop proprietors, garment makers, and nuns all lent money. [262] That nunneries would operate finance offices (discretely, no doubt) should be no surprise; the church was successful at recruiting unmarried women and widows, along with their inheritances from parents, knights, and lords. [263]

Consumer loans were small and short term, typically repaid in a few weeks or months, almost always less than a year. [264] Security was common. Like pawnbrokers of later eras, many lenders would take possession of physical goods – typically more valuable than the amount of the loan – and return the security on repayment of the advance, likely with some increment for interest. [265]

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[261] Jordan, *supra* note 1 at 15.

[262] Id. at 19-20. (Women accounted for an estimated 10-15 percent of the personal loans in some medieval towns.)

[263] Cantor, *supra* note 14, Ch. 11.

[264] Id. at Ch. 26.

[265] Id.

Thanks to the widespread participation by people with primary occupations in other trades, competition in credit likely preceded competition in most other necessities and luxuries. Even without a single dedicated moneylender around, merchants with natural monopolies in their principal trades could be competing for borrowers. The only leatherworker in town may idle funds or excess inventory that he could use to attract cash-strapped customers. If so, he had to make the terms sufficiently attractive to compete with the blacksmith willing to sell on credit and with grocers allowing customers to run a tab. The arrival of banks and finance companies in larger towns would intensify the competition, but it started before they opened their doors. As Jordan put it:

In any case, there is no doubt whatever that strong networks, supported by kinship, friendship and respect, often existed within the world of male lending and borrowing, among women borrowers and lenders, and sometimes among women and men involved together in credit transactions...Overlapping patterns of borrowing and lending are easily documentable: the rustic temporarily strapped for cash one harvestide could be a benefactor to a former benefactor the next.[266]

A common interest rate in these networks was two pennies per pound per week, 43.33 percent on an annual basis, but the loans were small and short term, repaid in a few weeks or months, so the "amount of interest paid could be quite reasonable."[267] Extensions occurred, of course: *prolongations, prorogationes, elongamentia, elongations, and provisiones*. But almost all small loans were repaid in well under a year.[268]

Credit markets were more efficient in larger towns and cities, and in economies where currency replaced barter as a medium of exchange. Among the most noticeable distinctions between villages and towns were merchants and institutions dedicated to lending and borrowing.[269] In good times (and large towns were signs of good times) borrowers could find a host of lenders willing to float a loan until the crop came in or finance a kiln at the expanding pottery store.

Because credit transactions were often recorded on the books of merchants and lenders, historians have been able to ascertain some of the terms and conditions that characterized numerous transactions. Thus, the credit markets across times and places can be compared and examined for signs of competition. The most extensive records come from Homer and Sylla, who studied credit markets, how they operated, who participated, and most significantly the

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[266] Jordan, *supra* note 1 at 26.

[267] Id. (citation omitted).

[268] Id. (citation omitted).

[269] Id.

interest rates they charged. The data they compiled is consistent with the hypothesis that the conditions of competition would suggest.

Evidence indicates that the cost of credit fell as markets grew and matured – as more lenders got into the business and they found more ways of directing money to valued uses. Annual interest rates of 20 percent to 50 percent appear in the earliest records of civilization, around the fifth to the third millennium BC. Subsequent centuries saw rates declining to around 25 percent to 40 percent.[270] Merchant bankers in major cities had by then developed large and sophisticated financing businesses. They competed with temples, some of which had accumulated significant wealth of their own. With these developments, interest rates continued to decline. In the first millennium BC, rates of 20 percent and less were more frequently reported.

Ancient Greece left numerous records of loans of all types, including personal loans, in the fifth and fourth centuries BC. Commercial rates were reported at 10 percent and less. Some of the earliest recorded personal loans varied widely – from 10 percent to several hundred percent, with some short-term loans capturing returns of a 1.5 percent per day. For most credit, however, rates remained low and declined over time. The temple at Delos, a major lender in Athens, reported rates above 10 percent in the third century BC, dropping to below 10 percent in the second century, and then difficulty finding any borrowers at all.[271] Borrowing did not stop, of course. The temple's competitors must have taken its business away.

Another indication of competition comes from comparisons of financial centers and frontiers. Not surprisingly, financial activity was intense in the great cities, where merchants of many types competed with dedicated creditors and other wealth holders to present a multitude of sources of credit. The evidence from Rome is less robust, as a result of the need to evade usury proscriptions, but the reports that survived from the height of the Empire indicate that rates were typically lower in Rome than in the provinces.[272]

Historians have found little evidence of interest rates during the Dark Ages, between the fall of Rome and the rise of commerce in the second millennium AD, but a comparison of the dawn of Middle Ages with the end of the Empire reveals again the importance of markets and competition. After Rome fell to invaders, the city lost most of its population – three quarters or more. Across Europe major cities saw significant declines as well. Economic activity returned to

[270] Id. (These rates became the basis for the customary rates of 33 percent on grain and 20 percent on silver in the Code of Hammurabi).

[271] Id. at 1387.

[272] Homer, *supra* note 2 at 1714.

farms and villages, in which small markets and self-sufficiency became the main source of goods and services, including credit.

In the Middle Ages, new trade centers eclipsed Rome and Athens, and credit markets resumed their expansion to international proportions. The largest markets, port cities like Amsterdam, Genoa, and Venice, gave Europe its best rates. The best short-term commercial loans in the twelfth and thirteenth centuries were available in Italy at 20 percent to 25 percent. Amsterdam was offering 10-16 percent, and 8-10 percent on longer-term annuities and mortgages. In smaller, but still significant markets, like the large fairs in Champagne, France, merchants could borrow at 15–20 percent.[273] Rates in England, where economic development lagged far behind Europe, were twice as high.

Interest rates on personal loans were often reported at their legal limits (perhaps dubious indicators of true costs, given the hazards of recording illegal activity), but consumers in Italy and Flanders appeared to find the cheapest credit in Europe. Of course, the interest rates on personal loans reflected risks, costs, and circumstances that commercial creditors could more easily control:

The mechanics of lending as individuals to other individuals on pawns or real estate or general credit is complex, burdensome, and potentially unpleasant, however giltedged the collateral. This difference of convenience alone may outweigh the factor of risk in explaining the tendency of ancients to hoard metal and invest in land.[274]

In other words, the costs of investigating, the complications of transacting, and the uncertainties of repayment tend to make lenders reluctant to part with their money. The principle can be stated in its converse formulation. The less a transaction costs to process, and the easier it is to assess a risk, the more likely a borrower would be to obtain funds. In a market where the borrower has alternatives, the lower cost would be reflected in lower rates.

Given the greater variations in the rates on personal loans, and the unknown circumstances associated with them, the more reliable indicators of the conditions of credit markets are probably loans negotiated by commercial interests. They were in the market more frequently, better able to acquire more information about alternative sources, and in possession of more documentation that could satisfy cautious lenders. Consumers, artisans and shopkeepers who

[273] Id. at 2410, 2481 ("The Champagne fairs attracted merchants and bankers from all parts of Europe. Here the prince granted a special peace, guards, immunities from tariffs and seizures, and immunity from the prohibition of usury, provided that fixed maximum rates of interest were observed. There were six Champagne fairs a year, and each continued for six weeks.")

[274] Id. at 1700.

wanted to borrow had fewer options and presented more risks, which could be expected to result in greater variations in rates. Personal pawn loans in Italy were capped at 10-20 percent in the Thirteenth Century, at 43 percent in England, 300 percent in Provence, and 175 percent in Germany.[275]

International money flows would gradually narrow differences in rates. That credit was becoming a world market was obvious in the accounts the financial capitals of the seventeenth and eighteenth centuries. Amsterdam became the commercial center of Europe in the 1600s, and borrowers found better rates there than in England or France.[276] As Homer and Sylla observed: "When the yield on safe investments in London rose well above the level in Amsterdam, Dutch capital flowed to London, and the rate of exchange moved in favor of London. Dutch capital in this way supported the exchange value of sterling in several crises."[277]

Comparisons between the cities and the frontiers in Colonial America revealed similar patterns. From rich historical records, scholars have reconstructed the details of an economy that rivals any era before or since in the reliance on credit. Almost a cashless society, early America could not have had commerce without credit. Currency was rare in the colonies and rarer still on the frontier, even for wealthy citizens and merchants. Shwartz, Flynn and Karahan, surveying the literature, reported the widespread findings that coinage arriving from England did not stay long, as it was a preferred medium for import payments.[278] That could have left buyers and sellers without the ability to conduct business, had they not come up with a creative solution. Credit became a dominant medium of exchange. In the case of one craftsman, "it is evident that very little cash changed hands in his [craftsman] shop. Money, particularly small change, was always scarce, ..." and "Credit rather than cash was the rule everywhere."[279] Without extensive credit, supporting both domestic transactions and imports, commerce would have ground to a halt. As Flynn, et al. put it:

Given the well-known problem of paucity of coinage in the colonies, it appears that merchant account book credit serves ubiquitously as a substitute currency. Furthermore, Bridenbaugh (1990, 154) asserts, "From an economic point of view the use of credit was indispensable

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[275] Homer and Sylla, *supra* note 2 at 2418.

[276] Id. ("Another contemporary said, "it is a great advantage for the Traffick of Holland that money may be taken up by merchants at 3 ½% for a year without pawn or pledge." Amsterdam merchants are cited as borrowing at 3-4 ½% and lending in England and France at 6% or better.")

[277] Homer and Sylla, *supra* note 2.

[278] Jeremy T. Schwartz, David T. Flynn, & Gökhan Karahan, *Merchant Account Books, Credit Sales, and Financial Development* ACCOUNTING AND FINANCE RESEARCH Vol. 7, No. 3; 2018

[279] Id.at 155, quoting "Bridenbaugh (1990, 153-154),

because of the shortage of circulating medium and it undeniably encouraged productive activity." Hawtrey (1950) makes similar comments in the context of what he terms the pure credit economy. These observations suggest that credit is efficient. Personal credit...was the best financing system available.[280]

An examination of books documenting thousands of sales of 56 colonial merchants found that 98 percent of the recorded transactions were conducted on credit.[281] Since credit transactions were more likely to be recorded than their cash counterparts, the ledgers likely exaggerate the disparity, but cash sales would have to be multiplied many-fold to outnumber the credit tallies. The authors calculated where the payment forms would have stood if only one cash sale of every 100 had been recorded. Credit would still account for 40 percent of the sales, a significant share. One Connecticut merchant at the time estimated he dealt more than half the time in credit; his sales broke down to around 60 percent credit, 30 percent cash, and 10 percent barter.[282]

For the wealthy, credit replaced the coin of the realm. Thomas Hancock, the uncle of the revolutionary John (whom he raised after John's father died) was a wealthy merchant, but not by the measure of his cash transactions. He used credit: "...although he valued what he bought and sold in terms of money, [he] seems to have handled money itself remarkably seldom."[283] While credit helped build the Hancock family fortune, borrowing was not confined to the colonial upper class. Borrowers of lesser means were even more unlikely to be carrying much cash. They could get credit as well, but undoubtedly not on the same terms as the Hancocks. In one account of country borrowers coming to the store where they were constantly in debt, their options were to "take what they bring without Liberty to choose for themselves" if they wanted the merchants to "stay long enough for their pay."[284]

The store was not the only source of loans for farmers and trappers. Credit networks spread into rural communities and the untamed frontier, as Stobart described in The Routledge Companion to the History, of Retailing:

Once it is recognized that most goods and work had market prices, the idea that one commodity was traded for another disappears... Even in the fur trade, easily imagined as based on barter, extending credit was normal, and a pricing system allowed valuing the variety of furs delivered

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[280] Id. at 154.

[281] Id. at 159. (Only the recorded transactions survive; cash sales were likely underreported may not have been noted.)

[282] Id.

[283] Id. at 155

[284] Id. at 156. (internal citation omitted)

and goods purchased by indigenous traders....A further element to exchanges through the shop were third-party transactions, in which a credit on one customer's account was charged to another's. [A]n extensive web of ...shoemakers, joiners, shopkeepers and the like bound...neighbors together and created an interdependent community. [285]

For rich or poor, according to Flynn, "Credit was vital to the economy of colonial America and much of the individual prosperity and success in the colonies was due to credit. Networks of credit stretched across the Atlantic from Britain to the major port cities and into the interior of the country allowing exchange to occur (Bridenbaugh, 1990, 154)." ...The domestic forms of credit were relatively long-term instruments that allowed individuals to consume beyond current means. .... The use of credit, the duration of credit instruments, and the methods of incorporating interest show credit as an important method of exchange and the economy of colonial America to be very complex and sophisticated. [286]

Ubiquitous credit – offered by virtually everyone from financiers, to merchants, to crafters, to neighbors – suggests that conditions were favorable for competition in colonial America. The data are consistent with the descriptions. Although the anecdotal nature of old books and ledgers does not allow definitive empirical conclusions, aggregations that have been done indicate implicit rates generally ranging from 3.75 percent to 7 percent, in the New England colonies, mostly below the legal limits in effect at the time. [287] Moreover, the rates in the most developed and populous markets typically beat the rates in the hinterlands:

The Western frontier was not inhibited, as the early American colonies seem to have been, by the English tradition of moderate interest rates or by the 6 percent convention brought to New England by its early settlers. The West did not enjoy the access to the London money market that colonial merchants and planters maintained; in fact, it enjoyed only limited access to eastern American money markets. Money was scarce, opportunity was great, and local debtors paid accordingly. [288]

After the founding of the nation and a century of development, variations of interest rates in the United States suggest patterns reminiscent of Colonial days. In the 1800s, money centers on the east coast offered interest rates that were relatively stable or declining over the century, and they were lower than rates further inland. Commercial paper in New York City, for example, traded at

[285] Stobart, Howard, The Routledge Companion to the History of Retailing (2018).

[286] Flynn, David. *Credit in the Colonial American Economy*, EH.NET ENCYCLOPEDIA, Robert Whaples.ed. March 16, 2008, available at http://eh.net/encyclopedia/credit-in-the-colonial-american-economy/.

[287] Id. (reporting occasional examples of higher rates).

[288] Homer and Sylla, *supra* note 2 Ch. 16.

rates above 10 percent in the 1830s, gradually dropping to under 5 percent in the 1890s. To the west, even in larger cities, rates were higher.

"In Milwaukee during the 1840's a moderate rate of interest for bank loans and personal loans was 10-12% per annum. ...By 1873-193 such rates were quoted at 7-10% per annum. In Indiana [the] common rate by contract is quoted at about 50% per annum during the early decades of the century. (505) ...In 1879 Wyoming banks customarily charged 12% a year for mortgages and for ordinary trade credit; in fact, this was sometimes deducted in advance. (506) ...In the 1880's, in Colorado, 12% was a usual rate for a bank to charge. (509) In 1879, a Montana banker pointed out that "18% was the lowest rate known in Montana." By 1884 he said that his rates were down to 12-15% and the longest term was six months. (510)[289]

No doubt some of the differences in rates across regions and over time reflected greater risks of investing at long distances, greater returns from previously untapped regions, local conditions and business cycles. National and international capital markets are the starting point for interest rates, and local borrowers must navigate through the turbulent wake of improvident sovereigns, expensive wars, famines, and natural disasters. A single dry season could produce credit shortages and interest spikes as farmers and merchants scramble to make it until next year. Peacetime, predictable commerce, and a steady money supply contribute to rate stability. The historical data do not permit precise dissection of the factors influencing rates, but over time, the cost of credit appears to be correlated with the conditions of the markets in which it could be measured.

Still, in case after case, where the conditions of competition were more favorable, credit has been cheaper, often dramatically so. Borrowers far from commercial centers could pay half again as much for a loan, sometimes more, than their counterparts in the big cities. The terms could be far worse, when the scarcity of funds, the lack of information, or the distress of the buyer raised the costs and risks of lending. Wide variations in terms were reported more often as credit transactions took place farther away from smoothly operating markets where funds, information, and creditors were more plentiful.

The Commission's Report acknowledged the dependence of American consumers on credit, both on the farms and in the cities in the eighteenth and nineteenth centuries. When coins were scarce, promises to pay became currency – the means of exchange at merchants of all types.[290] By the middle of the 19th century, credit in the form of installment payments became a popular

[289] Homer and Sylla, *supra* note 2 at 5977

[290] Report of The National Commission on Consumer Finance, Consumer Credit in the United States, 214 (Dec. 1972) at 5.

method of purchasing pianos, books, and sewing machines. If a merchant was unwilling to extend credit, most consumers could probably find several others who would.

According to the Commission's Report, merchants retained their role as sources of credit when economic activity gravitated to the urban centers of the industrial revolution, and growing cities presented a variety of alternatives to merchants' advances. Flourishing markets emerged for small loans as consumers who ran short between paydays found finance companies eager to dispense quick cash at high rates. Pawnbrokers, lenders since antiquity, remained a popular option as well, and entirely new institutions appeared with innovative alternatives. The Commission's Report noted the arrival of credit unions and Morris Plan Banks around 1910, and it could have noted many others – immigrant banks, industrial banks, and thrift institutions, for example. Largely absent from the origins of consumer credit, however, was the commercial bank. With few exceptions, commercial banks did not join the direct competition for consumer finance until it was well developed in the United States.[291] To the contrary, they shunned consumers and focused instead on the demands of businesses and the wealthy clients who owned and ran them. Most consumers of a century ago would be considered unbanked today.

Competition, primarily among merchants and manufacturers, gave rise to consumer credit. Banks were involved, to the extent they extended credit to the companies who lent to consumers, but consumer credit grew with the banks in the background. An example is the Sewing Machine War, which Singer won in the United States at the turn of the century, not because of patents, many of which had expired, but because of credit:

But why did Singer's prove to be the one with staying power? ...Edward Clark...created the company's early advertising campaigns and devised the "hire-purchase plan" for customers who could not afford the machine's high price—the first installment-payment plan in the United States.[292]

Perhaps no historical episode illustrates the synergy between credit, competition, and economic growth better than the origins of automobile financing. In the early 20th century, consumer installment loans helped the automobile business evolve from scattered workshops to sprawling factories. Henry Ford built his first car in 1896 and used the $200 he got from its buyer to work

[291] Id. at 5. Of course, to the extent that commercial served the companies financing consumer loans, the banks played an indirect role.

[292] Alex Palmer, *How Singer Won the Sewing Machine War*, SMITHSONIAN MAGAZINE, (July 14, 2015), available at https://www.smithsonianmag.com/smithsonian-institution/how-singer-won-sewing-machine-war-180955919/. (citing Adam Mossoff, *The Rise and Fall of the First American Patent Thicket: The Sewing Machine War of the 1850s*, ARIZONA LAW REVIEW, Vol. 53, pp. 165-211, (2011)).

on the next.[293] Recognizing the need for more capital to increase capacity (some thirty manufacturers were producing 2,500 motor vehicles a year by 1899),[294] he went into debt, defaulted, and declared bankruptcy. Then he tried again, failed again, and declared again. Undaunted, he took another foray into capital markets, this time with the Ford Motor Company (FMC) in 1903, which he envisioned would "build a motor car for the great multitude…so low in price that no man will be unable to own one."[295] The Model T was the result of that vision when it arrived in dealerships with a price tag of $850 in 1908.

Most working families could not write checks for $850, worth about $24,000 in 2020 dollars. The Model T would have remained a rare luxury reserved for the rich, if the average consumer could not borrow the money to buy a car. In an era when personal debt still carried a social stigma (moralists of the day decried "consumptive credit"), Ford declined to become the creditor of his own customers. Instead of financing purchases of the Model T, the company offered a Weekly Purchase Plan, in which buyers could deposit $5 a week at their dealership until they had saved enough to buy their new cars.[296] Most consumers who started a plan never finished it. Ford might have foundered yet again if consumers had not found another way to buy their cars. They did, thanks to finance companies that entered a market Ford had shunned. The Model T succeeded, and Ford led the industrialization of the twentieth century, as the time to manufacture a car fell from one every fourteen hours in 1913 to one every ten seconds in 1925.[297] By then, over 1,600 finance

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293 *Henry Ford's first car, the Quadricycle, debuts*, AUTOMOTIVE NEWS, (June 05, 2018) available at https://www.autonews.com/article/20180605/CCHISTORY/180609865/henry-ford-s-first-car-the-quadricycle-debuts#:~:text=Henry%20Ford%20unveils%20the%20Quadricycle,and%20a%20buggy%20bench%20seat.

294 *Automobile History,* History.com, https://www.history.com/topics/inventions/automobiles

295 Ford quote available at Shannon McGarry, *Moving the Millions: How Henry Ford made the Automobile Affordable for Every American*, Autodesk.com, https://www.autodesk.com/products/fusion-360/blog/moving-millions-henry-ford-made-automobile-affordable-every-american/.)

296 1924 Ford Model T Advertisement, *How Did He Ever Get the Money to Buy a Car?* Henry Ford Museum of American Innovation, https://www.thehenryford.org/collections-and-research/digital-collections/artifact/355541/.

297 Id. at https://www.thehenryford.org/collections-and-research/digital-collections/artifact/149966. Neglecting the demand for consumer finance may have cost Ford. The Motor Company improved efficiency, reduced prices, updated models, and added options, but it steadfastly refused to finance the cars it sold. Its smaller competitor, General Motors, recognized the importance of credit to car buyers and in 1919 created its own financing arm, General Motors Acceptance Corporation. For the next decade, GM customers without enough cash to buy a car could choose between

companies were in the market, and two thirds of automobiles were bought on credit.[298] In 1929, an estimated 30 percent of working families (rising to half of nonfarm families) owned cars.[299] Twenty-three million cars were registered in the United States in 1930,[300] when the Census counted 29 million families.[301]

The history of credit and cars is hardly unique. Consumer debt rose from an estimated $3.3 billion to $7.6 billion from 1920 to 1929.[302] Automobiles accounted for about half of it in 1926, followed by household furniture (with 19 percent), pianos (7 percent), while sewing machines, phonographs, washing machines, radios, jewelry, clothes, and tractors rounded out the top ten categories.[303] Good customers of The Hudson store could obtain a personal charge token, the forerunner of modern credit cards. Marshall Field's strategy was to know its customers personally. By 1930, most appliances, radios and furniture were bought on the installment plan.[304]

Innovation drove competition in the early decades of consumer credit. The thrift industry, an innovation of the 1800s, became a major source of large consumer loans of the twentieth century. These precursors of savings and loans (known as "building and loans" then) were membership institutions that collected savings from shareholders to finance home purchases. After the first one opened in 1831, they spread to a handful of states before the Civil War, and then to every state in the union by 1890. In 1914, one survey counted 6,600 thrifts nationwide.[305] Their loans differed from bank mortgages. Thrifts offered longer terms and amortized loans, whereas banks typically collected interest during the term and payment in full

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GMAC and external financing. They took advantage of the competition, flocked into dealerships and drove out in new cars. Not until 1928, when Ford introduced the Model A, did the company join the credit competition. By then it was too late to prevent GM from overtaking Ford as the nation's top auto maker.

298 Lendol Calder, Financing The American Dream; A Cultural History Of Consumer Credit, 192 (1999).

299 Id at 203.

300 US Department of Transportation, STATE MOTOR VEHICLE REGISTRATIONS, BY YEARS, 1900 – 1995, available at https://www.fhwa.dot.gov/ohim/summary95/mv200.pdf, (including commercial and private ownership).

301 US Census, 1930 Census: Families in the United States by Type and Size, available at

302 Calder supra note 60, at 18 (citing Martha L. Olney, Buy Now Pay Later: Advertising, Credit, and Consumer Durables in the 1920's (1991)).

303 Id. at 203.

304 Stephen Smith, *The American Dream and Consumer Credit*, AMERICAN PUBLIC MEDIA, (2018), http://americanradioworks.publicradio.org/features/americandream/b1.html;

305 David Mason, SAVINGS AND LOAN INDUSTRY (U.S.) (2004), available at https://eh.net/encyclopedia/savings-and-loan-industry-u-s/. At the time, according to FDIC, about 25,000 state and national commercial banks were operating in the US., *see Historical Timeline*, FDIC https://www.fdic.gov/about/history/timeline/1900-1919.html 1911

at expiration. From all the sources available, one study found urban real estate mortgages had risen from $11 billion in 1920 to $27 billion in 1929.[306]

A variation of the thrift model that developed in the early 1800s, specifically for a consumer clientele, was the mutual savings bank (MSB), the first of which were founded by charitable organizations. Their original purpose was, as described in an FDIC history, "to help the working and lower classes by providing a safe place where the small saver, then shunned by commercial banks, could deposit money and earn interest." At first these banks invested very conservatively, confining their portfolios to government bonds and other safe securities. By the turn of the century, they were financing a wider variety of long-term loans, including mortgages, and they grew rapidly, from 10 in 1820 to 637 in 1910. Total deposits grew from $1 million to more than $3 billion.[307]

Financial innovation accelerated in the early 1900s, with the arrival of two new types of institutions. In 1909, the first credit unions opened, adapting a similar business model that entrepreneurs had established in Europe.[308] The model caught on quickly, on the strength of its organization as a nonprofit entity, which gave them insights into the creditworthiness of their members and cost advantages of tax-free status. These advantages allowed them to offer lower rates on loans. A year later came the first Morris Plan Bank, which offered a financing method that appealed to consumers who could not qualify for legal loans under the usury laws at the time. Morris Plan Banks avoided usury sanctions by dispensing only part of the loan as cash and keeping part in the form of a hypothetical deposit, which had the effect of raising the interest rate on the borrowed cash (and also the benefit of building capital). Sometimes called "industrial banks" because many of their customers labored in mills and factories, Morris Plan Banks obtained specific legislative authorization in many states. By one estimate, over a hundred Morris Plan Banks operating in 142 cities had $220 million in loans outstanding in 1931.[309]

A challenge familiar to a large portion of the American population today also confronted their counterparts a century ago. Nearly 30 million Europeans, including Henry Ford's parents, came to America during the so-called Age of Mass Migration. The number of newcomers was remarkable, considering the US population did not pass 100 million residents until the 1920

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306 Calder, *supra* note 60.

307 Federal Deposit Insurance Corporation (FDIC). History of the Eighties: Lessons for the Future. Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s. FDIC. Ch. 6 (1997).

308 National Credit Union Administration, *Historical Timeline of Credit Unions*, available at https://www.mycreditunion.gov/about-credit-unions/historical-timeline.

309 David Mushinski, Ronnie Phillips, *The Role of Morris Plan Lending Institutions in Expanding Consumer Microcredit in the United States,* in G. YAGO ET AL. (EDS) ENTREPRENEURSHIP IN EMERGING DOMESTIC MARKETS (2008)

Census. Between 1870 and 1920, immigration lifted the foreign-born population of the United States to 14 percent (a level not seen again until 2010).

For many immigrants, running low on cash and looking for a job, the steamship agents who had handled their voyages became their first financial institutions. These agents opened what came to be known as 'immigrant banks.'[310] Generally unregulated (and therefore difficult to count) the banks communicated in native languages, kept immigrants' savings, and offered other services, among which were personal bonds and remittances.[311] The latter became big business for the immigrant banks, which collectively handled an estimated 90 percent of money transfers from new Americans to their families back in their nations of origin. The success of the steamship agents attracted other merchants who combined financial services with sales of consumer goods in immigrant communities. At their peak, thousands of immigrant banks were providing financial services for otherwise unbanked Americans.

For smaller loans, consumers went where people in a bind had long gone – to merchants who sold on account; to small-dollar lenders, pawnshops, friends, and families. Like the general store on the frontier, the twentieth-century store was still an important source of credit. A popular article purportedly revealing "What Every Grocer Knows" reported in 1913 that "there weren't 15 percent of the people who paid cash and got cash discounts."[312]

Shoppers who did not have the cash to put food on the table and could not find a merchant who sold on account had other alternatives, and they resorted to them often. A popular option was to patronize one of the many small-dollar lending companies nearby in the neighborhoods. In urban areas of more than 30,000 residents, according to a study in 1911, one worker in five borrowed from a small-dollar lender.[313] Another survey of New York City's municipal employees that same year found one in three had taken out small loans.[314] Among these lenders were companies that made "salary loans," the precursors of today's payday loans:

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310 See, e.g. Ramsey, W., Dillingham, W., & United States. Congress . Senate. (1910). Immigrant banks (61st Cong., 2d sess. Senate. Doc. 381). Washington: Govt. print off.

311 Influence of Immigrant Banks and Agencies in America, available at https://www.gjenvick.com/Immigration/OtherIssuesAndProblems/1913-InfluenceOfImmigrantBanksAndAgenciesInAmerica.html, *quoting* the Commission on Immigration, *Problem of Immigration in Massachusetts* (1914).

312 What Every Grocer Knows: Fifteen Years' Observation of the American Housekeeper by a Grocery Clerk, MCCLURES 41, 125-129 (September 1913). (cited in Calder 216).

313 Lendol Calder, *supra* note 60, at 118.

314 *Id.*

One 1908 study concluded that there were at least thirty known salary lenders operating in New York City, and likely many others whose presence could not be ascertained because they did not advertise publicly....One transportation company employee in New York City estimated that at least 90 percent of his coworkers had taken out salary loans."[315]

Data on early small-dollar lenders remain elusive because usury laws in many states prohibited the rates they charged, and the most aggressive lenders had reason to be the least conspicuous. Lenders that advertised and operated in prominent locations were easy targets for prosecutors. New York brought hundreds of cases against small-dollar lenders. At first the enforcement focused on abusive collection practices, but the goal was to stop all illegal lenders, and the cases mounted – 1,000 in just five months in 1913. One of the defendants that year was D.H. Tollman, owner of one of the largest finance companies in the nation, who was sentenced to six months in prison for usury.[316] Tollman closed his New York offices. In 2014, the prosecutors announced that all the illegal lenders in business when the sweep began had been shut down. Jail time for usury infractions was a risk that lenders had to take into account. Consumers also took tremendous risks taking out these loans; going underground was a way to mitigate that risk.

Behind the campaign against finance companies were reformers, like the Charity Organization Society and the Russell Sage Foundation. They monitored the finance companies, gave assistance to the prosecutors, counseled customers against excessive borrowing, and offered loans at legal rates through lending societies that opened offices in several large cities.[317] Even with law enforcement on their side and lower rates than private lenders, the societies struggled to attract customers and cover the costs of making small loans at legal rates. Meanwhile, although prosecutions drove hundreds of lenders away, the authorities could not stop the influx of finance companies that opened up when others closed down.

After years of legal and political battles, the finance companies and charities finally reached a compromise and joined forces to collaborate on small-loan reforms, a result of which was the Uniform Small Loan Law. Its primary innovation was to raise the caps on interest rates. Versions of the law were ultimately adopted in half the states, and although the usury ceilings were not high enough to make the smallest loans profitable, the more permissive landscape allowed the established companies to retain a profitable business. At peace with their erstwhile

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[315] Anne Fleming, The Borrower's Tale: A History of Poor Debtors in Lochner Era New York City, LAW AND HISTORY REVIEW, Vol. 30, No. 4 (2012) at 1054.

[316] Calder (1999), *supra* note 60, at 128-132.

[317] *Id.* at 124-28.

competitors and critics, the finance companies acquired the more successful lending societies, and the sector grew to become a major source of consumer credit throughout the 20th century.[318]

For the borrower whose need was too small or prospects too dim to interest the upmarket finance company, credit had to come from somewhere else. As it does today, a large population fit this description at the turn of the twentieth century:

> Poverty remained a fact of life for most working-class families and a condition of existence for many. The slightest disturbance in the balance between income and expenses, whether brought on by illness, unemployment, injury, or … a relative in need, sent families looking for money. In these situations, children could be put out to work, meals could be cut back, boarders could be taken in, and charity solicited, but sometimes borrowing money was the only way to pay the bills.[319]

Somewhere else for many borrowers was the same source that had served ancient civilizations – the pawnbroker. In twentieth-century America, pawnbrokers grew to an estimated 2,000 in 300 cities by 1911, and they became frequent creditors to consumers who had no attractive alternatives. Pawnbrokers were sometimes weekly financial bridges for homemakers whose bills came due before payday and seasonal support for mechanics who did not need tools when jobs were scarce. In the Bowery of New York, a reporter estimated that almost the entire population held at least one pawn ticket, and most had a dozen or more in the slow winter months.[320] Other studies offered a range of estimates, most with the caveat that many pawn customers would not admit to their use. Like the buyers on accounts at the stores, the most frequent patrons of pawnshops were women, who typically handled family budgets.

Remedial loan organizations entered the pawn markets as well and brought their model of counseling combined with lending to pawn customers. The Provident Loan Society in New York, for example, attracted customers by offering lower interest rates and nicer surroundings than the typical private pawnshop. Along with these emoluments, however, came more complicated applications and more stringent qualifications for borrowers.[321] Many customers preferred the

318 See, e.g. Fleming (2012), *supra* note 40, at 1054 (citing CLARENCE W. WASSAM, THE SALARY LOAN BUSINESS IN NEW YORK CITY: A REPORT PREPARED UNDER THE DIRECTION OF THE BUREAU OF SOCIAL RESEARCH, NEW YORK SCHOOL OF PHILANTHROPY 25-26 (1908).

319 Calder (1999), *supra* note 60, at 42, (citing PETER SHERGOLD, WORKING-CLASS LIFE: THE AMERICAN STANDARD IN COMPARATIVE PERSPECTIVE, 1899-1913 (1982) (internal citations and quotation marks removed)).

320 Id. at 44 (citing Charles Barnard, *Pawnshops and Small Borrowers*, CHAUTAQUAN, 19, 72 (April 1894)

321 WENDY WOLOSON, IN HOCK: PAWNING IN AMERICA FROM INDEPEDENCE THROUGH THE GREAT DEPRESSION, 174 (2012).

convenience of the private pawnbroker. Transactions were simpler. Neighborhood proprietors were familiar. Credit was easier. Charities did not take a large share of the pawnbrokers' trade, although a century later, both types of institutions still compete. Provident Loan Society, for example, operates five pawnshops in New York City in 2020, as well as an online store.[322] Yellowpages.com lists over 200 other pawnshops in the City.[323]

Despite its contribution to the rising standard of living in the early twentieth century, and notwithstanding the efforts to rehabilitate its reputation, consumer credit could not cast off its stigma as a symptom of society's moral decay. Too many consumers were borrowing too much, according to moral authorities and charitable organizations. The perceived risk worsened as standards of living rose at increasingly rapid rates and debt outstanding rose with them. Describing the attitude of the time and the crescendo it reached in the mid-twenties, the cultural history, "Financing the American Dream," summarized the moral attitudes and public angst:

As debt levels rose, so did public anxiety over what was disparagingly termed "consumptive" credit. A loud chorus of critics alleged that the installment plan was a grave threat to public morals and a harbinger of economic catastrophe...As it was, many who bought goods on the installment plan felt embarrassed to admit it."[324]

Moralists of the time often invoked misogynistic myths to make their point. Women became natural targets of the disparagement of credit, because they did much of the shopping and took out many of the small loans in the growing American cities. Pawnshop investigators in the 1860s observed that three quarters of the patrons were women.[325] In 1905, a home economist wrote, "the spending of money, in the majority of cases, falls to the women."[326] They borrowed an estimated 80 percent of the consumer credit extended in 1914, according to a study in a bankers' periodical.[327] Women's management of credit set the pretext for a best-selling novella, *Keeping Up with Lizzie*, which portrayed a woman whose borrowing brings her family to the brink of ruin. The book inspired the nickname of the Model T (Tin Lizzie), a sequel (*Charge It! Or Keeping Up with Harry)* a 1921 movie, and a comic strip, "Keeping Up with the Joneses" which

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322 *See* https://providentloan.com/en/

323 *See* https://www.yellowpages.com/new-york-city-ny/pawn-shops?page=7. Accessed 11/13/20.

324 Calder (1999), *supra* note 60, at 211.

325 Id. at 48 (citing "Pawnbrokery in New York," *Hours at Home* 7 (July 1968) at 247, 252; "The Loaners' Association in New York City," *Bankers Magazine and Statistical Register* 16 (September 1861), 212.

326 Id. at 218 (citing Belle Squire, "Women and Money Spending," *Harper's Bazar* (December 1905) at 1143).

327 Id. (citing W.H. Kniffen Jr., "The Theory and Practice of Credit," *Bankers Magazine,* 89 (December 1914) at 664).

delivered regular disdain of conspicuous consumption in the middle class.[328] The difference between myths and reality must have been obvious to the multitudes that entrusted family finances to women, but the epithets endured for decades.

Fear that consumers' profligacy portended catastrophe was unfounded. Instead, consumer credit proved resilient during the worst credit crisis in United States history. The crisis began with the Crash of 1929 and extended into the Great Depression had little to do with consumer credit.[329] Both shocks could be traced to monetary policies intended to stem global capital flows that were draining the United States of gold as European central banks were increasing their holdings. In order to staunch the outflow, the Fed raised interest rates in 1928 and 1929. Higher US rates would make dollars more desirable to international investors and ease demand for gold in US vaults. More expensive credit could also stifle economic activity, but policymakers saw merit in cooling the economy and deflating the credit that was heating it. The rate increases had their intended effects. By mid-1929, flagging economic activity turned investors' optimism to anxiety. The stock market reached its peak in early September and then fluctuated widely in September and October, reflecting anxiety among investors. Anxiety grew into panic in late October, when frantic selling of stocks caused the market to crash, wiping out investors as plummeting prices erased the collateral that had backed their margin loans.

The Crash of 1929 was devastating to thousands of institutions and individuals, but it was not the cause of a decade of despair. By early 1930, stocks had regained half the ground lost in the crash, and more importantly, credit markets were largely intact. As Bernanke found in his seminal study of the Depression, "except for a brief period of liquidation of speculation loans after the stock market crash, credit outstanding declined very little before October 1930—this despite a 25 percent fall in industrial production that had occurred by that time."[330] The ruined investors of 1929 were a minority of Americans.

It was not until the credit crisis spread through the banking system that the Great Depression gripped the nation. Shrinking payrolls and increasing anxiety sent people to their banks to withdraw funds –to pay bills or to keep at home. In effect, customers were calling loans they had made to banks, and those who hoarded cash made out well, as falling price levels increased the

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328 Id.

329 See, e.g. "Stock Market Crash of 1929," *Federal Reserve History,* available at https://www.federalreservehistory.org/essays/stock-market-crash-of-1929; Timothy Cogley, "Monetary Policy and the Great Crash of 1929: A Bursting Bubble or Collapsing Fundamentals?" FRBSF Economic Letter 1999-10 (March 26, 1999) available at https://www.frbsf.org/economic-research/publications/economic-letter/1999/march/monetary-policy-and-the-great-crash-of-1929-a-bursting-bubble-or-collapsing-fundamentals/#:~:text=Between%20January%20and%20July%201928,a%20year%20following%20a%20recession.

330 Ben S. Bernanke. "*Nonmonetary Effects of the Financial Crisis in Propagation of the Great Depression,*" American Economic Review, June 1983, AMERICAN ECONOMIC REVIEW, v. 73, pp. 257-76. (June 1983).

value of dollars. But mounting demands for deposits came in as bank reserves were dwindling due to tight monetary policies imposed by the Federal Reserve.[331] The weakest banks ran out of reserves first. When they closed without honoring their obligations, sensational headlines spread the news, and depositors elsewhere rushed to their banks, causing more to fail. The runs came in waves, and the waves crested in panics that overwhelmed thousands of banks in 1930, 1931 and 1932. By 1933, authorities in 37 states had partially or completely closed their banks. In March, just as President Roosevelt was taking office, the tide engulphed the lender of last resort, when the twelve Federal Reserve Banks closed their doors. In less than three years, a third of the nation's banks had failed, depositors had lost $1.3 billion, credit had become unaffordable for many – if available at any price,[332] and falling prices magnified long-term debts, such as mortgages on houses and farms, to unsustainable levels. At the worst of the mortgage crisis, defaults were estimated at around 44 percent in some markets, but the percentage of defaults that resulted in foreclosures did not reach the levels seen in the financial crisis of 2008.[333]

Ironically, however, the debts that dragged the economy down were not loans to consumers. As Bernanke, Friedman and Schwartz, and others have shown, the credit markets that failed were those in which the Fed, banks, businesses, and investors were the primary participants. In contrast to the failed loans supporting stock speculation was the performance of consumer lending. Consumer credit began the 1930s on a more prudential foundation than business borrowing, and competition enabled consumers to find refuge from the turbulence that devastated capital markets. Although consumer credit shrank with the economy, individual loans did not carry the same risk as corporate debt and margin loans. In 1930, the average car

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[331] A popular monetary theory at the time, which prescribed contracting credit when the economy declined, had adherents at the Fed. The result was a shrinking of the reserves that banks needed to fulfill depositors' demands for withdrawals and a third of the money supply disappearing by 1933. Gary Richardson, Alejandro Komai, Michael Gou, and Daniel Park, *Stock Market Crash of 1929*, FEDERAL RESERVE HISTORY (2013). Available at https://www.federalreservehistory.org/essays/stock_market_crash_of_1929

[332] See, e.g., MILTON FRIEDMAN AND ANNA J. SCHWARTZ. A MONETARY HISTORY OF THE UNITED STATES, 1867-1960 (1963). The panic did not subside until an emergency order, one of the first actions of the newly inaugurated President Roosevelt, temporarily closed all the nation's banks. They reopened once the government relaxed the restrictions that had contributed to the scarcity credit, in a Presidential order on March 6, 1933 that was ratified by the Emergency Banking Act, three days later.

[333] David Wheelock, The Federal Response to Home Mortgage Distress: Lessons from the Great Depression,

FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, *90*(3, Part 1), pp. 133-48 at 138 (2008), available at https://files.stlouisfed.org/files/htdocs/publications/review/08/05/Wheelock.pdf. Another parallel between the Great Depression and the 2007-2009 crisis comes from a recent study finding that investor-owned real estate, more than owner-occupied housing, contributed to defaults and foreclosures in the latter period. See, Stefania Albanesi,

Giacomo De Giorgi, Jaromir Nosal, *Credit Growth and the Financial Crisis: A New Narrative*, SSRN (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3683219.

loan had less than five months of payments remaining.[334] Virtually all were paid off. Auto repossessions in the darkest years of the decade did not exceed 0.5 percent of autos financed. Delinquencies rose at general finance companies as well but remained below the rates on commercial loans. At the two largest finance companies, Household Finance Company charged off only 1.02 percent of its loans in 1930, and Beneficial Finance repossessed collateral on only 0.025 percent of its chattel mortgages that year.[335] One report could find only two failures of finance companies in 1930, in contrast to over 800 banks in just two months at yearend.[336] Pawnshops suffered losses as well, but they had assumed most of the risk of a recession. Unlike other financial institutions, pawnbrokers had no recourse against their customers, and their principal capital – the inventory of pawned items – was losing value and liquidity.

The dynamics of competition in consumer finance can be seen in the sector's performance as the Depression dragged on. While banks were closing and commercial credit was shrinking, consumer lenders were expanding. In the year after the crash, Beneficial and Household opened 80 offices between them and increased loans by 12.8 and 18.8 percent, respectively, in 1930. One Household office made over 300,000 loans in a year. It also turned away 200,000 applicants, reflecting the poor prospects of many consumers as the Depression was spreading.[337] But consumers had other alternatives, and they turned to them as well.

Retailers intensified their competitive efforts in the face of the downturn, in part by ramping up consumer lending. In July 1930, Montgomery Ward blanketed the country with advertisements announcing that all items in the catalog (except groceries) would be available on time payments. Sears responded with a rate reduction on its installment sales. Competitors followed suit, and the credit they extended grew sales. Between 1932 and 1937 the four major mail-order retailers quadrupled sales on credit.[338] Other retailers – department stores, clothiers, furniture stores, and jewelers – likewise increased installment lending.

At the end of the decade, a Census Bureau retrospective on the worst of the Depression observed that "consumers did not repudiate debts en masse…."[339] One way they were able to avoid default was by borrowing to pay off previous loans. According to NBER, between 25 and 75 percent of personal-finance loans from 1934 to 1937 were made to refinance existing debts. Consumer

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[334] CALDER (1999), *supra* note 60, at 266.

[335] CALDER (1999), *supra* note 60, at 270 (citing *Business Week*, 11 February 1931, at 14).

[336] CALDER (1999), *supra* note 60, 271.

[337] CALDER (1999), *supra* note 60, at 268.

[338] CALDER (1999), supra note 60, at 275 (citing Nugent, Consumer Credit and Economic Stability at 110)

[339] Id. (citing, U.S. Bureau of the Census, *Sixteenth Census: 1940 … Retail Trade: 1939, Part I* (GPO, 1941) at 40.)

borrowers fared better, and consumer lenders performed better, than their commercial counterparts did in the Depression.

Some commercial banks recognized the opportunities that consumer lending offered, and the more enterprising institutions entered the market as well. One of the first was National City Bank in New York, which opened a personal loan department in 1928.[340] Between 1929 and 1936 the number of commercial banks making consumer loans more than tripled, from 208 to 685.[341] Business lending continued to lag during the thirties, and a contraction in 1937 erased much of the recovery that had begun in 1933. By the end of the decade, bank balance sheets gave a disappointing reflection of the overall economy. Total bank lending had dropped by more than half, but most of the decline came from business credit; an encouraging exception was the proportion of loans that banks made to consumers, which doubled from 9 percent in 1929 to 20 percent ten years later.[342] Consumer credit had helped stabilize a commercial sector that was struggling to regain momentum.

The entry of commercial banks into the competition for consumer loans gradually displaced another institution. With the federal interest caps on customer deposits (set at zero for demand deposits), commercial banks gained some of the advantages that Morris Plan Banks had used to enhance their returns.[343] No longer unique, the Plans that had entered the market "when there were not adequate institutions to supply consumer credit [departed after] commercial banks had adopted their basic lending practices," began to exit.[344] In the words of the Commission, "Morris Plan banks paved the way for commercial banks to enter instalment lending and became virtually indistinguishable from those banks whenever they were given the privilege of accepting demand deposits."[345] When they became indistinguishable from more efficient alternatives, Morris Plan Banks could not compete. It did not help competitors of commercial banks when regulators outlawed the payment of competitive interest rates on deposits in order to bolster the banks' profits and stability:

NCCF (1972), *supra* note 52, at 93.

341 CALDER (1999), *supra* note 60, at 285 (citing NUGENT, CONSUMER CREDIT AND ECONOMIC STABILITY (1939), at 343; other statistics in paragraph from Ch. 6).

342 Id. at 283-86.

343 David Mushinski, Ronnie Phillips, *The Role of Morris Plan Lending Institutions in Expanding Consumer Microcredit in the United States*, in G. YAGO ET AL. (EDS) ENTREPRENEURSHIP IN EMERGING DOMESTIC MARKETS 121 (2008).

344 Id.

345 NCCF (1972), *supra* note 52, at 5.

> [T]he potential profitability of established banks was improved by the prohibition of paying interest on demand deposits and the delegation of power to the Board of Governors to set maximum time deposit rates, a power which was exercised under Regulation Q. Not surprisingly economic studies of the industry found that substantial rents were earned by banks in the New Deal era. Ignoring the culpability of the Federal Reserve in failing to mitigate the shocks of the early 1930s and thereby driving many more banks to the wall, policy makers and regulators took the system of unit banking as a given and saw the restriction of competition as a means to ensuring the solvency and profitability of banks.[346]

Ironically, the rescue of the banking system also put mutual savings banks at a disadvantage. They had been more resilient than commercial banks during the Depression. An FDIC history noted that they were "far less prone to bank runs than either commercial banks or savings and loan associations. Indeed, nearly every year during the 1930s MSBs experienced a net savings inflow…[and] continued to prosper during and long after the Depression."[347] From 1930 to 1940, the sector lost less than 10 percent of its institutions, while the numbers of banks and savings and loan institutions each declined by a third. Thrifts, due to their specialty in mortgages and their relaxation of lending standards, were especially hard hit by falling real estate prices.[348] Mortgagors had been buying with smaller down payments by 1929. They had little cushion when the deflation of the early 1930s wiped out their equity and slashed farm income. The MSBs had insisted on down payments at traditional levels – around 50 percent. Their reputation for safety and soundness had been a competitive advantage, until the government offered deposit insurance to the other banks and thrifts.[349]

Much of the prosperity of the first half of the twentieth century in the United States, and the worst economic crisis, can be traced to developments in financial markets. When credit was abundant, economic activity advanced and standards of living rose, as the Roaring Twenties demonstrated. When credit was scarce, production declined and jobs disappeared, most seriously during the Great Depression. Influential in both cases was the lender of last resort.

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346 Eugene White, *Lessons From The History Of Bank Examination And Supervision In The United States, 1863-2008*, in ALFREDO GIGLIOBIANCO AND GIANNI TONIOLO, EDS., FINANCIAL MARKET REGULATION IN THE WAKE OF FINANCIAL CRISES: THE HISTORICAL EXPERIENCE (2009), available at https://www.bancaditalia.it/pubblicazioni/collana-seminari-convegni/2009-0001/1_volume_regolazione.pdf.

347 Federal Deposit Insurance Corporation (FDIC), History of the Eighties: Lessons for the Future. Vol. 1, An Examination of the Banking Crises of the 1980s and Early 1990s. FDIC, Ch. 6, (1997).

348 David Wheelock, The Federal Response to Home Mortgage Distress:

Lessons from the Great Depression, FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, 90(3, Part 1), pp. 133-48 (2008).

349 DANIEL R. WADHWANI, WHY DOES THE US HAVE A WEAK MUTUAL SAVINGS BANKS SECTOR?, World Savings Banks Institute (2011), https://www.wsbi-esbg.org/SiteCollectionDocuments/WadhwaniWeb.pdf

When the Fed allowed credit to expand, the economy grew. When monetary policy precipitated a contraction of credit, the economy suffered the consequences.

Fortunately for many consumers, other sources of credit were available. Merchants, finance companies, credit unions, and other financial institutions gave their customers the wherewithal to share the wealth of a growing economy. These sources also offered some insulation from tumultuous capital markets that buffeted heavy industries and commercial banks. Financial innovators developed new methods to attract funds and new ways to supply credit to consumers. Financial entrepreneurs entered markets and expanded as demand for credit grew. Competition was keen. In good times and bad, it gave consumers access to credit.

Access to credit, unfortunately, was not available to all consumers, including many who were well-qualified by all objective measures of creditworthiness. When this happens, a market has failed. As stated at the outset of this chapter, competition cannot work for people excluded from the market, and the history of credit is replete with accounts of discrimination and the pain that the discrimination inflicted on those targeted. The United States is no exception to that history. Exclusion has been a part of legal status and economic life in America since before the Revolution and up to the present. Ethnic, religious, racial, sexual, and other forms of discrimination did not begin in the Americas, but in many respects, exclusion reached its zenith here. The most enduring episode in America was a deliberate deprivation of the human rights, followed by a failure to protect those rights once they were granted, of African Americans. Other populations suffered varying forms and degrees of discrimination as well. Women were denied the right to vote for the first century and a half of US history and denied other rights for another century. They, too, suffered consequences of legal marginalization in credit markets, as the NCCF documented in 1972,[350] and as is described further in Chapter 10.

But marginalization is inadequate to describe the exclusion of African Americans from credit markets. As slaves, they were generally prohibited from holding property, accumulating it, and trading it.[351] Penalties for being caught with property ranged from forfeiture to flagellation to incarceration. Occasionally, slaves could avoid the strictures, for example when they were hired out by their owner to work for someone else and they were allowed to keep some of the compensation. Some localities adopted a system whereby slaves were assigned discrete tasks, after the completion of which they could work for themselves.[352] However, the most common

350 Chapter 10 discusses the NCCF's findings in more detail.

351 See, Charles Lewis Nier III, THE SHADOW OF CREDIT: THE HISTORICAL ORIGINS OF RACIAL PREDATORY LENDING AND ITS IMPACT UPON AFRICAN AMERICAN WEALTH ACCUMULATION, Univ. Penn. Jnl. Law and Social Change [Vol. II], (2007-08) 131-94 (surveying literature).

352 Id. at 138.

circumstance was the gang system, which sometimes allowed slaves to plant gardens and keep household items but provided no meaningful opportunity for wealth accumulation. On the eve of the Civil War, 4 million of the 31 million Americans[353] were officially excluded from credit markets, as they were denied the most fundamental rights and privileges of other people.

Reconstruction was intended to address these deprivations. The Freedmen's Bureau (Bureau), established in March of 1865, was tasked with distributing land and social services that could help slaves transition to economic freedom. Recognizing the need for a credit market for the former slaves, Congress also created the Freedman's Savings and Trust Bank (FSTB), where they could save and borrow to support their new farms.[354] Neither the Bureau nor the FSTB lasted, and both left broken promises in the aftermath. The Bureau's land transfers were reversed by orders of President Johnson, federal forces abandoned the south, and KKK vigilantes displaced law enforcement in many communities. Reauthorization became increasingly uncertain as representatives of the readmitted southern states reasserted influence in Congress, and it dismantled the Bureau in 1872. The FSTB did not last much longer. It collapsed in 1874, as a result of mismanagement and bad investments. About half its customers lost all they had deposited, while the other half recovered about 60 percent.[355]

Without the FSTB, the rural south would be left with numerous credit deserts. State chartered banks focused on commercial business in urban areas, and national banks returned very slowly after nearly disappearing from the south during the War. It mattered little to African American farmers whether a national bank was nearby. A national bank would likely lend only to borrowers who could offer land or assets as collateral.[356]

The remnants of Reconstruction were officially abandoned in 1877, with the compromise that gave the presidency to Rutherford Hayes and ceded control of the southern states to their own governments. For freed slaves, the regression to economic and legal subjugation came quickly. Their economy descended into a system that W.E.B. Dubois judged worse than the feudalism of the Middle Ages.[357] Without banks and other institutions of credit available, African Americans had few options beyond local merchants, and in many rural areas the merchant could be one

353 United States Census, Population of the United States in 1860, available at https://www2.census.gov/library/publications/decennial/1860/population/1860a-02.pdf?.

354 Id. at 151.

355 Id.

356 Id. at 152 (quoting, Roger Ransom and Richard Sutch, One Kind Of Freedom: The Economic Consequences Of Emancipation xii, 52 (1977)).

357 W. E. B. Du Bois, Black Reconstruction in America (The Oxford W. E. B. Du Bois) Ch. XIV (1999)

general store.[358] If a family needed an advance to put food on the table, their only source for credit might be the same monopolist who sold the food. Contracts were unreliable when the legal system could not be trusted to respect individual rights or to grant remedies when rights were violated, so African Americans relied at their peril on the instruments of credit: private promises and public enforcement. Tradition provided little guidance or comfort. Emancipated slaves did not inherit the economic and social relations that had evolved in Europe and forged the norms of feudal society. Centuries of bondage had forged institutions of expropriation, and there was little reason to expect those institutions to evolve into civil society and free markets after the failure of Reconstruction and the rise of Jim Crow.

Intolerable economic and legal conditions in the former slave states caused many African Americans to seek opportunity in the north. Those who could afford it began to move, and the movement became The Great Migration, which accelerated when the military mobilization for World War I depleted the labor force. The industries in the Midwest and Northeast needed workers to replace the soldiers. Workers came, with their families, an estimated 6 million strong between 1910 and 1970.[359] Like the immigrants from Europe, African Americans relied on family members, friends, and networks of neighbors to ease the transition from an agrarian existence to urban life and employment in the north.

Unlike the immigrants from Europe, Blacks faced many barriers like those they had been trying to escape. A historian of the Migration wrote, "There were "sundown towns" throughout the country that banned African-Americans after dark. The constitution of Oregon explicitly prohibited Black people from entering the state until 1926; whites-only signs could still be seen in store windows into the 1950s."[360] Restrictive covenants written into deeds prohibited property sales to African Americans. In Chicago as much as 85 percent of the city was off-limits.[361] And merchants – the source of credit for many consumers and the source of jobs for many women – practiced overt discrimination against people of color.[362] The attitudes of downtown merchants were exemplified by Marshall Field, who "was known for his disdain for Black shoppers and refused to put employees of color in visible positions that required

[358] Nier, *supra* note 121 at 153.

[359] United States Census Bureau, *The Great Migration, 1910 to 1970* (September 13, 2012), available at https://www.census.gov/dataviz/visualizations/020/.

[360] Isabell Wilkerson, The Long-Lasting Legacy of the Great Migration, Smithsonian Magazine, (September 2016).

[361] Id.

[362] Daniel A Graff, *Retail Workers* ENCYCLOPEDIA OF CHICAGO, Chicago Historical Society 2005

interaction with the store's predominately white, affluent clientele."[363] In New York, a retailer who pioneered installment sales of affordable furniture did not advance credit to African Americans.[364] Black shoppers found respect in the establishments of their own segregated neighborhoods, like the South Center Department Store, a famous establishment that opened in 1928 on King Drive (then South Parkway) in south Chicago.[365] Today, the store is gone, its site now a museum honoring Chicago's first African American mayor.

The struggle for legal, social, and economic rights has made progress, but the events of 2020 serve as a sobering reminder that equality remains elusive. The most blatant methods of discrimination have been prohibited, but reminders of its persistence reach us regularly, in news reports, in research studies, and in personal experiences. Credit markets, which consist of individual and personal transactions are suspectable to the practice of discrimination even with protective laws. Unfortunately, some of the most persistent discrimination has derived from the same sources as the most durable impediments to competition: laws, covenants, official enforcement, and social bigotry.

Competition, Regulation, and the Public Interest

Economic conditions, no matter how conducive to competition in credit markets, are not immutable. As in any other aspect of an economy, the performance of the financial sector can be affected by geopolitical turmoil, natural disasters, economic crises. Even the worst of these tend to subside. Other conditions, more devastating still, have lasted for centuries. Among the most important of these are social attitudes, legal rules, enforcement priorities, and the conduct of the competitors themselves. These all have the potential to change competition for good or ill, and thereby enhance or diminish the protection that a competitive credit sector can provide for consumers. Each by itself can be influential. In combination, as these forces typically operate, they can turn competitive markets into cartels that exercise monopoly power, collect premiums from borrowers, or drive borrowers out of the market entirely.

As described above, two animating impulses behind the official regulation of credit were an antipathy to the practice itself, and prejudice against participants. The origins of both can be traced to interpretations of western religions and the collaboration of churches and states in the first and second millennia AD. Sometimes the regulation was direct, discouraging anyone from

[363] Erick Johnson, *The Black department store on King Drive*, CRUSADER, (February 23, 2018), available at https://chicagocrusader.com/the-black-department-store-on-king-drive/.

[364] Calder, *supra* note 60 at 176 (citing Henry R.Mussey, The Fake Instalment Business (1904) (reprint, New York: Russell Sage Foundation 11-14 (1936)).

[365] Johnson, *supra* note 125.

lending. More often it was indirect, prohibiting lenders from charging for the use of their money. The penalties for disobedience were severe.

Before the religious authorities imposed their doctrines, civil laws – for example the Code of Hammurabi in 1750 BC – allowed interest (with limitations). The trends in interest rates from ancient Babylon and Greece reveal the gradual development of competitive markets and declining interest charges. The impact of these trends was especially painful for the major players in the market, the temples in possession of substantial wealth to invest. Competition relentlessly reduced the returns lenders could obtain, until the temples could not find borrowers at any discount they were willing to give. Whether the temples surrendered to market realities before Athens' fell to hostile armies is not clear, but most religions that dominated the Old World in the first two millennia faced similar problems. Fortunately for the later institutions, they were also in a position to set the terms for sharing the wealth of the moneylenders.

In Judaism, Christianity and Islam, charging interest for a loan ranged from immoral to heretical, and many governments followed suit with legal prohibitions. The original definition of usury encompassed collecting anything more than the amount originally advanced to a borrower. Numerous passages of the Torah (or the Old Testament) contain commands like these: "Thou shalt not lend upon interest to thy brother…. Unto a foreigner thou mayest lend upon interest…." Appeals for benevolence in the New Testament were likewise interpreted as admonitions against interest payments, and those admonitions became increasingly strict in successive ecumenical councils of the Catholic Church. In the Middle Ages, a lender caught charging interest could face excommunication, which was a devastating sentence. It could mean forfeiture of repayment, ostracism from society, loss of business, and escheatment to the crown of a usurer's estate upon their death. The plea rolls of thirteenth century England, for example, alleged that "William son of the parson of Lue, lately deceased, was a usurer in his lifetime, so that his goods and debts should belong to the king on that account."[366] The same fate befell a Florentine, Scaglia Tif.[367]

Usurers faced prosecution in the church, in the courts, and in Inquisition. Usurers were heretics.[368] Both civil and canonical courts took in cases and enforced the rules.[369] A study of

[366] Koyama, M., *Evading the 'Taint of Usury': The usury prohibition as a barrier to entry*, Explorations in Economic History 51 (2010), (quoting Calendar of Plea and Memoranda Rolls, Preserved among the archives of the Corporation of the City of London at Guildhall, 1323–1364, 1906, 675).

[367] Id.

[368] Id.

[369] Richard H. Helmholz, *Usury and the Medieval English Church Courts*, SPECULUM 61/2, 365 (1986), available at https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=11246&context=journal_articles at

court cases found that the usurious rate in the "great majority clustered between 12½% and 33 1/3%."[370] It mattered little where the cases appeared. Wherever a defendant might be fighting for their livelihood, the lawyers and judges who interpreted and adjudicated disputes likely held positions of power in the church, and the civil courts deferred:

The medieval church claimed exclusive jurisdiction to determine what conduct amounted to usury. The church did not, however, claim exclusive jurisdiction to punish proven usurers. At least some canonists allowed secular courts to undertake prosecution and enforcement of the law against usury, provided that enforcement followed the church's definition…."[371]

Civil prosecutions more often involved usurers on their deathbeds. Upon conviction, their estates were confiscated by the crown. The proceeds from these proceedings were especially useful when kings needed lords and knights to defend the borders or march off on crusades.

How often usurers faced the full force of these consequences is difficult to reconstruct on the basis of surviving records, but the available evidence reveals the economic effects of enforcement. Absolute prohibitions – the original definition of usury – allowed authorities to exercise prosecutorial discretion. With that discretion came the opportunity to make money on the exceptions, which the authorities did by granting expensive licenses to lenders. Moneylenders in Bruges, Florence, England and France, all had to pay the state for the license to lend in spite of the law.[372] The economic benefits of selective prosecution were no secret in the church:

> Thus in 1208, Innocent III advised the bishop of Arras to 'proceed cautiously in enforcing the decrees of the Lateran Council [against usury] because usurers are so numerous that if all were punished many churches would have to be shut down.'[373]

The church had little direct power over the Jews, but monarchs did, and their treatment of the Jewish moneylenders was consistent with the discipline of the church. Rulers episodically ostracized Jewish lenders, and then allowed them back. With Christians reluctant to fill the void, credit could become scarce, and it was too important to restrict. Not only did the people need credit, the treasury suffered in its absence as well. The returns from lending generated revenues that could be taxed.[374] Sovereigns who could share in the proceeds of lending found ways to

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[370] Id.

[371] Id.

[372] Id.

[373] Id. at 14 (citation omitted)

[374] Jordan, *supra* note 8, Ch. 10.

tolerate the lenders. Some envious authorities even tried to move in on the lucrative action and get more than a share, as Homer and Sylla wrote in their *History of Interest Rates*:

> [Creditors] were often tolerated and even officially licensed [sometimes] under the special protection of the prince, who participated through heavy license fees. ...Often "manifest usurers" were Jews... In the tenth or eleventh century they were partly supplanted by the Lombards....Later on, the State in the Low Countries and Italy set up public pawnshops which charged lower interest in an effort to supplant Lombards and Jews."[375]

Whether the regulation is an outright prohibition, albeit selectively enforced, or a cap on interest rates, anticompetitive effects are predictable and observable. Prohibiting interest or capping rates made it more difficult for commercial lenders to compete with landlords, churches, and other charitable institutions that had more acceptable ways of arranging deferred repayment. Taxes, tithes, and donations did not count as interest, which opened numerous loopholes to crowns and clerics who wanted to lend or borrow. One witness testifying for the accused in a usury trial in England dared to utter the hypocrisy. The defendant, he said, "took less than the arch-bishop takes from his debtors."[376]

Interest rate caps did not hurt everyone. They could benefit borrowers who qualified for the lowest rates, like lords, kings, and comfortable merchants.[377] At the same time, such laws encouraged lenders to ration credit and reject riskier borrowers or discriminate on some other basis. An investor who can make more on a risky equity than a risky loan will forsake the loan. Lenders who have more qualified applicants than funds at the capped rate can pick and choose among their borrowers.

Less appreciated than government and religious regulation of credit is the regulatory authority that competitors have been able to wield over themselves. Perhaps the most powerful economic regulators of the Middle Ages were the guilds. Commerce was costly and risky in early times, and merchants developed methods to reduce the costs and mitigate the risks. On roads and waterways, shippers needed protection, and there was safety in numbers. To capture what today would be called the benefit of the public goods or network effects, the merchants formed leagues, like the Hanseatic League, which collectively retained guarded escorts and arranged for security with port authorities. Local merchants faced different challenges that invited a collective response. Although town walls offered protection from the hazards of travel, shopkeepers were easier for tax collectors to find, inspectors to monitor, and municipalities to

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[375] Homer and Sylla, *supra* note 2 at ii.

[376] Helmholz, *supra* note 131.

[377] Koyama, *supra* note 128.

regulate. And there was always a threat to any trade from cheats, frauds, and counterfeiters. Merchants formed guilds to deal with their common concerns.

The lower costs that leagues and guilds could achieve would redound to the benefit of consumers in competitive markets. And undoubtedly some savings were passed on. Guilds maintained the reputation of their occupations. Stradivari, for example, mastered his craft in the Cremona guild of luthiers.[378] The benefits of maintaining quality are obvious. By the same token, generations of cooperation gave merchants the opportunities, skills, and mechanisms to moderate the competitive forces that could force them to share the savings from their efficiecies. The tension between these potential outcomes, one procompetitive the other anticompetitive, has figured prominently in competition policy.

As the canons of conduct covered ever more aspects of the quality and integrity of the crafters and traders they regulated, the guilds departed from their founding goals of protecting their members from violence, fraud, and oppression. Once firmly established, many concentrated on controlling competition. Cantor described the guild's progression from virtue to vice, as the merchants first organized to thwart blackmail, harassment, and oppressive taxes. Over time, the organization turned to regulation, dominated by master craftsmen who set standards, fixed prices and controlled entry into their crafts. By Cantor's account, the real power of the Middle Age cities resided in a small group of entrepreneurs who controlled the merchant guild and dominated the government.[379]

Regulations that govern the norms of commercial behavior can also undermine competition, and over time the guilds allowed their authority to extend beyond the integrity of the trade. Prices, qualities, ingredients, materials, methods, hiring, and many other aspects of a business became subject to guild rules and competitor enforcement. Apprentices labored long before they could become journeymen. Then journeymen found the path to master daunting as well, and that step was critical to competition, because a master crafter could become a competitor of the businesses that had enjoyed the fruits of their discounted labor.

Employers who offered substandard pay and working conditions could expect to lose employees, unless the employees had nowhere else to go. If all members of a trade imposed the same conditions, the employees could not better their lot elsewhere. The collective action of the guild could keep everyone in line. They were able to prevent entry from competitors who might charge less or pay more. In Milan, recounts Cantor, feuding spread from fights between clerics and lay

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[378] Jim Collins, *A Short History of the Violin*, CHICAGO MAGAZINE, JUNE 24, 2011, available at https://www.chicagomag.com/Chicago-Magazine/June-2011/String-Theory-and-the-Science-of-the-Violin-A-Short-History-of-the-Violin/.

[379] Cantor, *supra* note 14, Ch. 26.

people to struggles between upper and lower classes – the bourgeois and the rag pickers.[380] The phenomenon cut across markets. Substitute violins for rags, require luthiers to display the skills of Stradivari, and the result is predictable. The world would see fewer masters and fewer violins. The masters became wealthy, they paid guilds and governments for the protection, and product prices rose above competitive levels.

Guild feuds played out in credit markets as well. For example, the merchants of Florence banned pawnbrokers and other "manifest usurers," as those who charged interest were called.

> In the context of the decision to permit Jewish lending in sixteenth century Venice, Marino Sanuto wrote that 'others did not want to allow the Jews to stay in this land on any account, some out of pious righteousness and others because they themselves wanted to lend at interest, not at 20%, but at 40, 50 or more, as goes on at the Rialto.' Where the Jews could be kept out – as they were in the cities of Turin until 1424, Florence until 1437 and Milan, throughout the period – interest rates could be kept high.[381]

Rich merchants had more means of evading usury limits, since the credit they granted could be woven into more complex transactions. Price adjustments on commodities purchased on credit, insurance clauses in contracts for shipping, rent payments accompanying mortgage payments on land, and many other devices could be used to disguise interest. Loans to foreign borrowers were another way to escape the notice of usury investigators. Unlike "manifest" usury, which was transparent, the more elaborate evasions also created devices to hide the cost of credit. A more subtle, but important effect of the devices of avoidance, was to make the transacting process more expensive. Transaction costs can impede trade and competition, even when the goods and services involved are priced competitively.[382]

The restrictions on the crafters and merchants rewarded those who persevered. They avoided ruinous competition, restricted the entry of new rivals, and reaped high prices from the scarcity they created. As a result of their cooperation, the guilds generated wealth and power that rivaled the treasuries of clerics and lords. Guildhalls became prominent fixtures in larger medieval towns, as did the donations they made to the clergy, whose churches and cathedrals featured ornate windows and art dedicated to generous merchants.[383] Monuments to the wealth of the guilds can be seen in in the guildhalls preserved as museums in many European cities today.

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[380] Id.

[381] Koyama, *supra* note 128 (citation omitted)

[382] Id.

[383] Jordan, *supra* note 8, Ch. 9.

By 1776, the efforts of trade groups to suppress competition had caught the attention of Adam Smith, and they have been the subject of competition policy debates ever since.[384] In a famous passage from the *Wealth of Nations*, Smith declared that competitors "seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[385] Guilds offered just such occasions. The true goal of the guild, he wrote, was "to prevent this reduction of price, and consequently of wages and profit, by restraining that free competition which would most certainly occasion it…."[386]

The guilds got away with their anticompetitive ways by paying off the king, accused Smith, and he blamed their sovereign enabler for allowing it to happen.[387] Public policies that benefit the interest of producers, he asserted, should be pursued "only so far as it may be necessary for promoting that of the consumer."[388] The proposition that regulations should favor consumers, was so self-evident to Smith that he thought it absurd to try to prove it. A regulation that benefits the producer "comes at the expense of the public, who suffer when markets are distorted and competition is reduced."[389]

He urged that such conduct not be condoned, and authorities were beginning to see it his way. The Hanseatic League lost its influence with the ports and towns with which it negotiated when it shifted its mission from facilitating trade to restricting it, from improving safety to increasing prices. In a world where transportation was growing dramatically, alternatives to League membership became more plentiful, and the organization disintegrated.[390]

The protection of competition was taking root in the common law as well, long before Smith inveighed against the guilds and their enablers of anticompetitive arrangements. In 1601 the Queen's Bench decided *Darcy v. Allein,* now known as the *Case of Monopolies*,[391] in which the court held that a monopoly in the manufacture of playing cards, granted by Queen Elizabeth, was invalid, as it would "be employed for the private gain of the patentee, and for the prejudice

[384] Adam Smith, The Wealth of Nations, (1776) (Cannon Edition, 1965).

[385] Id. at 128.

[386] Id. at 147. (One of the gambits he recounted was the opposition of merchants near London to the extension of turnpikes into more remote regions. Better transportation enlarged markets, and larger markets allowed fewer monopolies,)

[387] Id.

[388] Smith, *supra* note 151 at 625.

[389] Id.

[390] Cantor, *supra* note 14.

[391] Darcy v. Allein, EngR 398 11 Co Rep 84 77 ER 1260 Noy; 173 Moore KB 671 1 Web Pat Cas 1 74 ER 1131; 77 Eng Rep 1260

of the weal public." Likewise, common-law courts have long been skeptical of agreements not to compete. The reason, as stated in the 1711 decision in *Mitchel v. Reynolds*, was because of "the mischief which may arise from them, 1st, to the party, by the loss of his livelihood...; 2dly, to the public, by depriving it of an [sic] useful member."[392] Such agreements would only be enforced when they were reasonably related to legitimate endeavors. The rental of the bakery was legitimate, and the promise of the renter not to siphon business from the tenant was reasonable. Thus Mitchel, who had rented Reynolds' bakery, could hold Reynolds to a promise not to open another bakery in their parish during the term of their lease.

This was the competition policy that the United States inherited. During its first century, the country largely left antitrust enforcement to private parties, who could litigate if necessary, to gain permission enter a trade or compete unencumbered in it. But only if the early American counterparts of Darcy or Reynolds were willing to plead their cases would anticompetitive practices face challenges in the courts. Meanwhile, as large manufacturers during the industrial revolution displaced the craftsmen and shopkeepers of the Middle Ages, lawyers created more sophisticated methods to coordinate their clients' behavior. The "corporations without charters" described in the Wealth of Nations evolved into trusts that could cover entire industries. By the end of the eighteenth century, these trusts were repeatedly accused of monopolistic and predatory behavior by customers and competitors.

The sanctions of common law – recoveries of losses, injunctions against conduct, and voiding of contracts – were insufficient to satisfy growing demands for action against profitable trusts and conspiracies. As long as competition control was a matter of common law, enforcement would depend upon aggrieved parties bringing violators to justice. Consumers and small businesses were not likely to take on the trusts in protracted and expensive litigation. Voters and taxpayers, however, could lobby for relief. They did, and Congress responded in 1890 with the Sherman Antitrust Act, which outlawed contracts, combinations and conspiracies in restraint of trade, and prohibited anticompetitive conduct by monopolists. The most serious violations under the Act were naked restraints: agreements that had no other purpose than to fix prices or suppress competition. Competitors who entered these combinations could end up serving time in prison and paying three times the damages their conspiracies had inflicted.

Enforcement of the Sherman Act was given to the Attorney General, and the Department of Justice embarked on prosecutions to dismantle trusts and agreements that had spread through sectors such as coal, meat, railroads, tobacco, oil, and steel. In 1897, the Supreme Court declared

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[392] Mitchell v. Reynolds 1 PWms 181, 24 ER 347, 45 Digest (Repl) 395, [1558-1774] All ER Rep 26; see generally, William L. Letwin, *The English Common Law Concerning Monopolies*, UNIV. OF CHICAGO LAW REV. 355, 377 n. 108 (1954)

illegal a rate-fixing agreement among members of a rail freight association.[393] The defense, that the agreement prevented ruinous competition, was rejected. In 1899, the Supreme Court upheld an injunction prohibiting six iron pipe manufacturers from coordinating bids.[394] Their defense, that the rigged prices were reasonable, was rejected. In 1911, the Supreme Court affirmed an order that broke the Standard Oil Company into thirty-three components.[395] The popularity of antitrust enforcement remains a lasting legacy of the presidency of Theodore Roosevelt – who brought dozens of cases from 1901 to 1909 and is often credited as the first trust-buster.

Notwithstanding the successful prosecutions, cautious rulings in the courts fueled sentiment for stricter and broader statutes. This inspired the passage of additional antitrust laws. In 1914, Congress passed the Clayton Act, which would prevent mergers and acquisitions that could harm competition; and the Federal Trade Commission Act, which would establish an agency to define and police unfair methods of competition. Those laws, along with the Sherman Act, are the principal pillars of antitrust policy today.

The early antitrust cases dealt with producers of physical goods and providers of capital-expensive services. Machinery, metalworking, textiles, agriculture and other activities had evolved into big businesses, and their owners had organized much like the guilds that Smith had condemned. Sectors such as these were, of course, the most visible manifestations of the industrial revolution.

In essence, industrial trusts were the inventions of financiers, many of whom helped underwrite and manage the combinations. New York banker J.P. Morgan, for example, invested in rail and steel companies, and then consolidated them. His power and influence grew to the stature that it was he (and his competitors), rather than the U.S. government, who rescued the nation from the financial panic of 1907.[396] For all their contributions, however, their power did not spare them from the trust-busting that began under Roosevelt and continued under Taft. The breakup of the trusts included removing some bankers from the company boards. For the most part, the financiers did not take the direct assaults that were reserved for the industrial empires they built, although they weathered intensive investigations by prosecutors and sensational hearings in Congress. Concentration of commercial credit did not provoke the public outcry that the integration of steel, rail, and farm implements did.

393 United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897)

394 Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899)

395 Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911)

396 Ron Chernow, The House of Morgan (1990), 121-129.

But the antitrust laws cover competition in financial services as well, and the history of enforcement includes notable cases in the sector. An early target of prosecutors invoking the Sherman Act was the Chicago Board of Trade, which required its members to observe numerous terms and conditions for buying and selling contracts and restricted them from trading outside the exchange the Board had created. The Board's restrictions escaped condemnation, however, when the Supreme Court held that the rules were reasonable efforts to enhance competition.[397] Antitrust enforcement abated during the Depression and World War II, but resumed in the Truman administration, which targeted the leading investment bankers for allegedly agreeing to suppress competition in securities offerings. The case ended much like the prosecution of the Board of Trade, with a finding that the bankers were competing.[398]

It was when the authorities turned their attention to commercial banks that antitrust laid down firm boundaries on the financial sector. Banking in Philadelphia provided the setting for a landmark decision on the relationship between concentration and competition in 1963. When two of the larger banks in the city tried to merge, the Antitrust Division of Department of Justice sought an injunction against the transaction on the grounds that it could reduce competition or tend to create a monopoly. The Supreme Court upheld the challenge, and with these words rejected the parties' defense that regulation rendered competition enforcement unnecessary in this sector:

> The fact that banking is a highly regulated industry critical to the Nation's welfare makes the play of competition not less important, but more so. At the price of some repetition, we note that, if the businessman is denied credit because his banking alternatives have been eliminated by mergers, the whole edifice of an entrepreneurial system is threatened; if the costs of banking services and credit are allowed to become excessive by the absence of competitive pressures, virtually all costs, in our credit economy, will be affected; and unless competition is allowed to fulfill its role as an economic regulator in the banking industry, the result may well be even more governmental regulation. Subject to narrow qualifications, it is surely the case that competition is our fundamental national economic policy, offering as it does the only alternative to the cartelization or governmental regimentation of large portions of the economy.[399]

Today, bank mergers are reviewed by the Department of Justice and the Federal Reserve Board.

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397 Chicago Board of Trade v. United States, 246 U.S. 231 (1918).

398 United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953).

399 United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 372 (1963)

As this Chapter recounts, other aspects of financial competition – from payment systems to credit ratings – have caught the attention of prosecutors and private plaintiffs. And antitrust will probe the complexities of transactions to pierce the disguises of anticompetitive practices in the sector. Agreements among competitors to fix the financial terms and conditions of sales – including credit – have long been condemned as illegal. The Supreme Court has periodically reminded lower courts and litigants "that an agreement to eliminate credit was a form of price fixing."[400] As such, those agreements were illegal *per se* (illegal without inquiry of their asserted benefits) when competitors entered them.[401] And the consequences of per se violations are severe – liability of three times the damage that the violation causes, and the prospect of a prison term.

International banks recently discovered the gravity of violating the Sherman Act when the United States charged that they had conspired to manipulate the London Interbank Offered Rate (LIBOR).[402] Since 2015 several banks have pled guilty, and their personnel have been convicted and sentenced to prison for participation in the conspiracy. Criminal penalties in the United States have exceeded $2 billion. Civil litigation, with additional billions of dollars of at stake, continues in tribunals around the world today. Adding the penalties for fraud (conspiracies can take cover under deception), the financial consequences of these cases to the banks have exceeded $10 billion.[403] The damage to borrowers, including consumers whose loan rates were pegged to LIBOR, could be a multiple of those billions.

In sum, competition policy was brought to the United States with English common law, but it took the nationwide trusts organized by financiers in the 19th century to inspire a robust public role in the prevention of anticompetitive and monopolistic conduct. An integrated system of regulation and enforcement has developed a robust capability to protect competition in a wide variety of credit markets, and to keep those markets open to entry, rivalry, and innovation. In the United States, much of the evolution of antitrust can be traced to the subject of this Chapter.

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400 Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643 [pin cite] (1980) (harkening back for emphasis to its rulings from 1905 and 1925, and to a common-law decision from 1861)

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402 Press Release, Thursday, March 10, 2016, Two Former Rabobank Traders Sentenced to Prison for Manipulating U.S. Dollar and Japanese Yen LIBOR Interest Rates, available at

https://www.justice.gov/opa/pr/two-former-rabobank-traders-sentenced-prison-manipulating-us-dollar-and-japanese-yen-libor

403 See, Council on Foreign Relations, "Understanding the Libor Scandal," (2016), available at https://www.cfr.org/backgrounder/understanding-libor-scandal

9. Innovation

Responsible innovation advances competition and inclusion in financial services. New products and services, or new ways to create or deliver existing ones, offer consumers lower prices, improved quality, and greater choice. Innovation is central to improving markets for consumers who have access to financial products and services as well as expanding markets to reach consumers who have been left out.

Today, innovation in financial services is almost synonymous with technology-enabled financial services, or "FinTech." Firms use expanded access to consumer data and new technology—particularly mobile technology—to offer a variety of new products and services. Over the past decade, markets throughout the world have seen rapid growth in the use of FinTech services such as mobile payments, peer-to-peer lending, digital savings, artificial intelligence (AI)-based financial management, use of alternative data, and exploration into underwriting models powered by AI and machine learning.

While a technology-fueled future appears bright, the benefits of any one innovation have their limits. Automated teller machines (ATMs) have not been particularly helpful to consumers without bank accounts from which to draw cash, just as online banking does not do much for such consumers today. The potential benefits of mobile payments and other mobile "apps" are similarly lost on consumers without mobile devices or on those who do not feel comfortable with certain technology. In addition, advanced credit scoring models cannot change the fact that some consumers lack the means to repay a loan, no matter how accurately it is priced. Significantly, bias can still persist in even the most advanced technological systems.

Innovation can also raise new risks for consumers. Nearly costless means of communication can lower prices but also raise the specter of repeated or otherwise unwanted contact from service providers. Data sharing and mobile services also invite fraudsters eager to access bank-account and payment information. Continually changing crediting scoring models could intentionally or unintentionally discriminate against individuals on the basis of non-credit factors, such as race, location information, or potentially even medical history.

Congress recognized innovation's importance by authorizing the Consumer Financial Protection Bureau (Bureau) to exercise its authorities for the purpose of, among other things, "ensuring that . . . markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation."[1] The challenge for the Bureau and other policymakers is to foster innovation and allow consumers to reap its benefits, while also guarding against potentially harmful effects.

First, this chapter draws on examples from the last several decades to examine some of the ways in which innovation has benefitted and presented risks to consumers. Second, using specific historical case studies, it explores how federal law can affect innovation. Third, it identifies non-rulemaking options that agencies have used to promote innovation, such as offices of innovation and regulatory sandboxes. Fourth, it reviews some of the recent technological developments that undergird FinTech innovation and considers particular products and services that make use of these technologies. Finally, it discusses potential regulatory frameworks that policymakers may wish to consider as they grapple with the benefits and risks of innovation.

9.1 Benefits and Risks of Innovation: Historical Examples

Earlier chapters discussed in detail key innovations in consumer financial services over the past century. It is worth briefly revisiting a few of those innovations to highlight how changes in practices or technology have affected consumers. Below, we review two products, ATMs and credit cards, that greatly increased consumers' ability to access funds and make payments. We then discuss the innovations in automobile lending before using advances in communication technology and changes in mortgage servicing practices to highlight some of the risks to consumers that innovation can entail.

9.1.1 ATMs

ATMs are an example of a technological innovation with obvious benefits for consumers. Prior to their invention, consumers wishing to draw funds from deposit accounts had to make a trip to a local bank branch and obtain the assistance of an employee in person. Bank branches' locations and "bankers' hours" thus limited where and when a consumer could access stored funds. Consumers with a check in hand had more options; department stores like Sears would

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[1] DFA, section 1021(b)(5) (12 U.S.C. § 5511(b)(5)).

cash checks as a way to draw in potential retail customers, but those consumers were still limited by the stores' locations and hours.[2]

Recognizing the potential to attract customers without lengthening hours or hiring more staff, banks began offering ATMs in the late 1960s and early 1970s. Initially, ATMs were slow to catch on in the U.S., but they numbered roughly 10,000 by the late 1970s as consumers began to value the benefits of obtaining cash, making deposits, and transferring funds at times convenient to them.[3] The growth of ATMs exploded after court decisions in the 1980s held that ATMs are not bank branches and therefore not subject to geographic restrictions on bank concentration, which removed a significant regulatory hurdle for expanding ATM networks across state lines.[4] And in the 1990s, ATMs unaffiliated with specific banks were increasingly common in stores and shops all across the country. Today, there are over 470,000 ATMs in the U.S., permitting consumers to engage in banking transactions without stepping foot in their bank—or in any bank at all.[5]

ATMs nonetheless have had their share of consumer protection issues. Fraud, a complicated issue to navigate for even the savviest of consumers, has been a consistent problem since inception. ATM-use fees have been a particular sore point for consumers. Although banks increasingly reimburse fees that their clients incur when using another bank's or an independent ATM, this benefit is reserved primarily for wealthier consumers who satisfy minimum-account-balance or similar requirements. ATM locations may also favor these wealthier consumers, as ATMs may not be located in the neighborhoods where low income or minority consumers live. Consumers of modest means often must choose between the time, expense, and inconvenience of traveling to an ATM that does not charge a fee or paying a fee to access their own money.[6]

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[2] Linda Rodriguez McRobbie, *The ATM is Dead. Long Live the ATM!*, SMITHSONIAN MAGAZINE, Jan. 15, 2015, https://www.smithsonianmag.com/history/atm-dead-long-live-atm-180953838/?all.

[3] Stan Sienkiewicz, *The Evolution of EFT Networks from ATMs to New On-Line Debit Payment Products*, Fed. Reserve Bank of Phila. Payment Cards Ctr. Discussion Paper No. 02-04, at 4 (Apr. 2002), https://www.philadelphiafed.org/-/media/consumer-finance-institute/payment-cards-center/publications/discussion-papers/2002/eftnetworks_042002.pdf?la=en.

[4] Indep. Bankers Ass' of N.Y. State v. Marine Midland Bank, 583 F. Supp. 1042 (W.D.N.Y. 1984), rev'd in part, vacated in part, and remanded, 757 F.2d 453 (2d Cir. 1985), cert. denied, 476 U.S. 1186 (1986).

[5] Lian An, *et al.*, *The Locational Study of ATMs in the U.S. by Ownership: ATM Analysis Based on National Data*, at 4 (2018), http://www.akleg.gov/basis/get_documents.asp?session=31&docid=22687#:~:text=Currently%2C%20there%20are%20approximately%20470%2C135,ATM%20fleets%20are%20as%20follows.

[6] The Covid-19 pandemic provided a particularly stark example of the lengths to which some consumers will go to find a preferred ATM. New York State provides unemployment benefits through direct deposit or on a debit card that Key

9.1.2 Credit Cards

Credit cards became one of the dominant forms of consumer credit during the second half of the 20th century, a development due to several innovations, including changes in technology, industry practice, and regulation. In the early 1900s, oil companies and department stores moved beyond ledger books and introduced proprietary cards that consumers could use to purchase items on credit from the issuing business. Sometimes made of metal and imprinted with the consumer's information through use of a "Charga-Plate," these cards helped to promote customer loyalty and afforded consumers the convenience of using one card to shop. However, these cards were generally limited for use at a single business and its branches.[7]

In 1946, John S. Biggins introduced his innovative "Charg-It" plan at Flatbush National Bank in Brooklyn, New York.[8] Similar to a modern credit card, the Charg-It plan permitted approved consumers to use credit when shopping at a variety of previously cash-only stores, such as grocers, butchers, and hardware sellers. Consumers took advantage of 30-day repayment terms, and stores that could not afford to offer credit could nonetheless accept it as payment, allowing them to compete with larger credit-granting department stores. The Bank, meanwhile, charged consumers 0.5 percent per month (or 6percent annually) for use of the revolving account and received 8 percent of each sale from the stores. Innovative as the Charg-It plan and similar ventures were, practical considerations narrowed the scope: Each day, stores had to leave sales slips with the Bank to earn reimbursement for that day's sales, limiting the plan's range to a roughly two-square block radius.[9]

Soon thereafter, the Diners Club pioneered the three-party card, and the Franklin National Bank of New York launched its bank credit card, laying the groundwork for a rapid expansion of credit cards beginning in the 1960s. As Chapter 2 explains, the growth of three-party credit cards was

Bank issues. Key Bank has a higher withdrawal limits than other banks and does not charge an ATM fee, making it a better option than other banks for many unemployed consumers. But it has only one ATM in New York City. Following mass pandemic-related unemployment, consumers lined up outside the ATM at all times of day, sometimes waiting two to three hours in lines of 50 to 60 people. Some consumers, many low income and people of color, valued the higher withdrawal limits and lack of fees so much that they traveled for hours from neighboring boroughs to reach the ATM in Manhattan. *See* Matthew Haag, *To Reach a Single A.T.M., a Line of Unemployed Stretches a Block*, N.Y. TIMES, June 5, 2020 (last updated July 7, 2020) https://www.nytimes.com/2020/06/05/nyregion/keybank-nyc-coronavirus.html.

[7] Merrill Fabry, *Now You Know: What Was the First Credit Card?*, TIME, Oct. 19, 2016, https://time.com/4512375/first-credit-card/; Jay MacDonald & Taylor Tompkins, *The History of Credit Cards*, CreditCards.com, July 11, 2017, https://www.creditcards.com/credit-card-news/history-of-credit-cards/; John S. Kiernan, *When Were Credit Card Invented? A Complete History*, WALLETHUB, June 12, 2015, https://wallethub.com/edu/cc/history-of-credit-cards/25894.

[8] LOUIS HYMAN, DEBTOR NATION: THE HISTORY OF AMERICA IN RED INK 146-47 (2012).

[9] *Id.*; Merrill Fabry, *Now You Know: What Was the First Credit Card?*, TIME, Oct. 19, 2016, https://time.com/4512375/first-credit-card/.

in large part a technological change that replaced less convenient forms of credit that consumers had used to purchase household goods. Credit cards have also replaced cash for many consumers, providing an ever-ready form of payment that does not require the time or costs of trips to an ATM and that facilitates online transactions. Credit cards further offer a great number of benefits aside from convenience, such as greater privacy and security compared to checks, better liability protections than cash, and—for wealthier consumers—perks like cash-back, airline miles, or special access to airport loungers or concert tickets.

Credit cards also have had their share of consumer protection concerns that Congress, regulators, and industry members have attempted to address. Fraud is a persistent problem, prompting Congress to provide consumers with dispute rights and limited liability for fraudulent transactions.[10] Meanwhile, issuers and merchants have increasingly turned to chip-enabled cards and have required consumers to provide a three-digit card verification value as security measures. Congress mandated additional disclosures to improve transparency and the ability to compare products.[11] The Bureau and others have brought enforcement actions against issuers that deceptively marketed or failed to provide promised add-on products, such as credit insurance or credit monitoring.[12]

9.1.3 Auto Financing

Unlike ATMs and credit cards, innovations in automobile financing relied less on technological advances than a change in market practices to meet consumer demand. As Appendix B to Chapter 8 details, Ford initially declined to offer credit in connection with its new Model T, offering layaway plans instead. Financing companies quickly stepped in to fill the credit void, followed by Ford's competitor, General Motors, pairing its cars with financing opportunities. Ford then joined the increasingly competitive automobile financing market, giving consumers multiple manufacturers and lenders from which to choose.

As with all innovations, automobile financing has raised consumer protection concerns. For example, automobile dealers' practice of negotiating sales prices raises the specter of intentional or unintentional discrimination on prohibited bases, especially when financing is part of the deal. Chapter 10 explores these issues in greater detail, but it is worth noting that some dealers

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[10] *See, e.g.,* Fair Credit Billing Act, 15 U.S.C. §§ 1666-1666j.

[11] Credit Card Accountability, Responsibility, and Disclosure Act of 2009, Pub. L. No. 111-24, 23 Stat. 1734 (2009).

[12] *See, e.g., In re First Nat'l Bank of Omaha,* No. 2016-CFPB-0014, Consent Order (Aug. 25, 2016), https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-first-national-bank-omaha-pay-3225-million-illegal-credit-card-practices/; *Consumer Fin. Protect. Bureau v. Affinion Grp. Holdings,* No. 3:14-cv-01005-VAB, Stipulated Final Judgment and Order (D. Conn. Oct. 27, 2015), https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-companies-for-unfair-billing-of-credit-card-add-on-products-and-services/.

have carved a niche through a simple innovation—no-haggle pricing—that avoids some issues that can result in discrimination. In the 1990s, Saturn's straightforward pricing practices attracted consumers who did not wish to negotiate. In particular, Saturn developed a reputation as a preferred dealer for women, who reported disrespectful or otherwise poor treatment at other automobile dealers.[13] Carmax adopted a similar policy in the used car markets, and some other dealers have since followed suit.

9.1.4 Autodialiers and Email

Other innovations have had significant drawbacks for consumers that continue to draw significant attention from regulators and market participants. Technological advances such as autodialers and email, for example, have greatly reduced the cost of communication but have led to consumers receiving too many unwanted contacts. Autodialers enable firms to use a program that automatically dials consumers' telephone numbers from a large database of stored numbers and connects the firm's employees to calls that consumers answer. While the savings from replacing live employees with autodialers theoretically benefits consumers through lower prices[14], it also has led to an onslaught of unsolicited marketing and debt collection calls to consumers. These calls are both bothersome and costly: The Federal Communications Commission (FCC) has found that they impose substantial costs on consumers.[15] Similarly, the almost-zero marginal cost of sending automated emails has enabled firms to repeatedly message consumers who may or may not have ever purchased any product or service from the firm. Email, of course, has substantial benefits for consumers, in both personal and financial contexts, but the presence of spam messages has been a consistent nuisance.

Congress and regulators have attempted to curb unwanted contacts through legislation and rulemakings that, among other things, limit the frequency of automated or other telephone calls

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[13] *See* George P. Blumberg, *To Sell a Car That Women Love, It Helps if Women Sell It*, N.Y. TIMES, Oct. 26, 2005, https://www.nytimes.com/2005/10/26/automobiles/autospecial/to-sell-a-car-that-women-love-it-helps-if-women.html; Jim Henry, *How Saturn went from Unique to Just Another One of the Crowd*, AUTOMATIVE NEWS, Sept. 14, 2008, https://www.autonews.com/article/20080914/ANA09/809150338/how-saturn-went-from-unique-to-just-another-one-of-the-crowd; Thomas J. Cosse & Terry M. Weisenberger, *Saturn Buyers: Are They Different?*, 5:4 J. MARKETING THEORY & PRAC. 77 (Fall 1997).

[14] In a market with downward sloping demand and marginal revenue curves, a reduction in marginal costs and average total costs should shift the supply curve down and to the right, increasing equilibrium quantities and reducing prices. The theoretical basis for this claim can be found in any microeconomics textbook, but readers can review WALTER NICHOLSON AND CHRISTOPHER SNYDER, MICROECONOMIC THEORY; BASIC PRINCIPLES AND EXTENSIONS, 11th, ed., Chapters 3 through 15 (2010).

[15] Fed. Commc'ns. Comm'n, *In re Rules & Regulations Implementing the Tel. Consumer Prot. Act of 1991*, 30 FCC Rcd. 7961, 8020 ¶ 118 (2015) ("In addition to the invasion of consumer privacy for all wireless consumers, the record confirms that some are charged for incoming calls and messages. These costs can be substantial when they result from the large numbers of voice calls and texts autodialers can generate.").

and give consumers the option to opt-out of unwanted calls, texts, or emails.[16] These efforts have been modestly successful, and it may be the market that ultimately provides the best check on abusive behavior. Email providers have long employed tools that divert likely spam or junk messages, and improved techniques serve as a marketing point for competing services. Likewise, telephone providers, in particular those offering mobile services, increasingly tout features that can identify likely marketing or scam calls and allow consumers to block specific callers. Consumers also now have the option of downloading third-party apps for their smartphones that are increasingly effective at detecting spam calls, texts, and emails, as well as blocking some legitimate calls—such as from debt collectors—that consumers may prefer to avoid.

9.1.5 Mortgage Servicing

Credit involves a sequence of transactions. For long term loans with frequent repayments and associated expenses the relationship between creditor and debtor requires sophisticated services that have become a line of business that creditors contract out to others. Decoupling ownership from servicing of mortgage loans has had profound consequences for consumers. While there is no need to repeat the extensive literature on this subject,[17] it is worth acknowledging that specialized mortgage servicers represent a market innovation. The innovation, however, separates services from a highly competitive retail market—mortgage origination. Competition among mortgage servicers focuses on creditors and, with incentives potentially at odds with consumers' interests (and in some cases with those of the creditor), it was inevitable that some servicers would fail to provide the assistance necessary to deal with the widespread delinquencies that triggered the 2008 financial crisis. Consequently, Congress, federal and state actors, and private litigants have stepped in to correct and prevent market failures that could contribute to servicing deficiencies. Regulatory changes, as well as increased investor emphasis on rehabilitating delinquent loans, have helped improve servicing standards, and a cadre of servicers that specialize in delinquent loans may prove to benefit some consumers.

[16] CAN-SPAM Act of 2003, 15 U.S.C. § 7701 *et seq.*; Telephone Consumer Protection Act of 1991, 47 U.S.C. § 227; Telemarketing and Consumer Fraud and Abuse Prevention Act, 15 U.S.C. § 6101 *et seq.*; 47 C.F.R. § 64.1200 *et seq.*; 47 C.F.R. § 64.1600 *et seq.*

[17] Bureau of Consumer Fin. Protect., *Mortgage Servicing Rules Under the Real Estate Settlement Act (Regulation X)*, 78 Fed. Reg. 10695, 10699-10702 (Feb. 14, 2013).

9.2 Regulatory Challenges: Historical Examples

A consistent theme from the last 50 years of consumer financial protection law is that policymakers have had difficulty predicting the future. Rapid changes in technology can change markets in ways that policymakers could not anticipate and sometimes more quickly than they are able to respond. Some laws intended to address a harmful market practice or perceived market failure may, within a short time, even created barriers to competition or innovative products and services. This section uses two federal laws, the Electronic Signatures in Global and National Commerce Act (E-Sign Act) and the Fair Debt Collection Practices Act (FDCPA), to examine how such barriers arise and how regulators struggle to overcome them.

9.2.1 The E-Sign Act

The E-Sign Act provides a lesson in how a law designed to foster innovation may quickly become a barrier to it. The explosion in internet-based commerce during the 1990s heralded a new, virtual marketplace in which consumers could increasingly purchase anything or manage their finances without physically visiting external locations. However, the novelty of online transactions raised concerns about how the parties to the transaction could authenticate each other's identity and trust in the transaction's validity and security. States addressed these concerns in patchwork fashion. By 1999, more than 40 states had electronic authentication laws, but no two were identical. "This inconsistency," a Congressional Report observed, "deter[red] businesses and consumers from using electronic signature technologies to authorize contracts or transactions."[18] Congress therefore enacted the E-Sign Act in 2000, establishing national rules governing the use of electronic signatures for transactions in interstate or foreign commerce.[19]

Of interest here, the legislation also included detailed rules about providing consumer disclosures. When a federal or state statute, regulation, or other law requires an institution to provide a notice or other information "in writing," the E-Sign Act permits the institution to send it electronically, subject to obtaining the consumer's consent and making several additional disclosures about the scope and withdrawal of consent.[20] The E-Sign Act further requires that

[18] S. Rep. No. 106-131, at 1-2 (1999).

[19] Pub. L. No. 106–229 (June 30, 2000), *codified at* 15 U.S.C. § 7001 *et seq.*

[20] The E-Sign Act imposes three general prerequisites to sending a notice electronically: (1) "the consumer has affirmatively consented to such use and has not withdrawn such consent"; (2) prior to consenting, the consumer receives clear and conspicuous statements that (a) consumer has right to paper copy of disclosure, after consent (and

institutions disclose the hardware and software requirements to access and retain electronic records and that the consumer's consent be given "in a manner that reasonably demonstrates that the consumer can access information in the electronic form that will be used to provide information that is the subject of the consent."[21]

From the perspective of the 106th Congress, these requirements may have appeared flexible and accommodating to changes in technology—that is, to innovation. Congress did not mandate any particular software or hardware requirements for electronic notices, a wise decision given the dramatic changes in computing capabilities over the ensuing two decades. Congress also prohibited agencies with rulemaking authority from adding to the E-Sign Act's requirements or re-imposing a paper-only requirement,[22] thus ensuring that additional regulations could not further deter the use of electronic notices. Disclosures about the scope and withdrawal of consent may have also seemed like fairly obvious safeguards.

The E-Sign Act has nonetheless created hurdles to providing electronic notices that may not substantially benefit consumers. The Bureau estimates that the required disclosures may be more than 1,000 words long,[23] which could take an average person 2 to 8 minutes to read or an institution's employee 6 to 10 minutes to recite aloud.[24] Since neither is likely to occur, and since digital space is plentiful, disclosures can accumulate and consumers can click-through them without reading as they attempt to complete a transaction.[25] Requiring that the consumer's consent "reasonably demonstrates" that the consumer can access the electronic notice imposes an additional procedural step and can create compliance questions about whether there has

before if there is such an option), (b) consumer has right to withdraw consent, and the procedures for doing so (and for updating the consumer's contact information), (c) the conditions or consequences of withdrawing consent, (d) any fees for withdrawing consent, or for the paper copy, and (e) the scope of the consent; and (3) the consumer (a) "prior to consenting, is provided with a statement of the hardware and software requirements for access to and retention of the electronic records," and (b) "consents electronically, or confirms his or her consent electronically, in a manner that reasonably demonstrates that the consumer can access information in the electronic form that will be used to provide the information that is the subject of the consent." E-Sign Act section 101(c)(1)(A)-(C); 15 U.S.C. § 7001(c)(1)(A)-(C). In addition, the E-Sign Act requires providing additional disclosures and re-obtaining the consumer's consent if, after the consumer originally consented, "a change in the hardware or software requirements needed to access or retain electronic records creates a material risk that the consumer will not be able to access or retain a subsequent electronic record that was the subject of the consent." E-Sign Act section 101(c)(1)(D); 15 U.S.C. § 7001(c)(1)(D).

[21] *Id.*

[22] E-Sign Act section 104(b)(2)(B), (c)(1); 15 U.S.C. § 7004(b)(2)(B), (c)(1).

[23] Bureau of Consumer Fin. Protect., *Debt Collection Practices (Regulation F – Proposed Rule)*, 84 FED. REG. 23274, 23361 (May 21, 2019).

[24] *See, e.g.*, Number of Words, *How Long Does It Take to Read 1000 Words?*, https://numberofwords.com/faq/how-long-read-1000-words/; Convert Words to Time, https://wordstotime.com/.

[25] *See* Chapter 7 (Information and Disclosure).

been such a demonstration.[26] The substance of the reasonable-demonstration requirement also may be antiquated, better suited to a time when software programs had widely different capabilities and when there was a genuine question as to whether a given consumer could open a particular type of electronic file. Today, formats such as PDF are widely available, free to download, and compatible with most operating systems, reducing concerns that consumers will consent to receiving notices that they cannot open.

The E-Sign Act's inconsistent application also produces anomalous results. It applies only when the statute or regulation requires a disclosure to be made "in writing."[27] It does not apply when the law does not specify a delivery method or when the law allows alternatives, such as "in writing or electronically."[28] That means institutions can provide many notices electronically without complying with the E-Sign Act's procedures. The E-Sign Act's applicability can vary even within a single regulation. For example, under Regulation Z (which implements the Truth in Lending Act (TILA)), an institution must comply with the E-Sign Act when providing electronic periodic statements for open-end loans but not for closed-end loans.[29] It is difficult to see how consumers benefit from the applications of these diverging regimes.

Federal agencies have limited authority to create exemptions from the E-Sign Act, as it imposes a fairly stringent two-part test for doing so.[30] An agency must find that the exemption (1) "is necessary to eliminate a substantial burden on electronic commerce," and (2) "will not increase the material risk of harm to consumers." Only the Federal Reserve Board appears to have made such findings. In 2007, it amended five regulations to exempt disclosures provided in situations where consumers access an application or advertisement for credit or other financial service online; the exemptions did not apply to other notices, such as account-opening disclosures,

[26] Compliance questions could include, for example, whether a "reasonabl[e] demonstrat[ion]" includes consumers' affirmations that they can access a particular type software or obtaining a consumer's consent on an HTML web page even though the disclosure will be in PDF. *See, e.g.*, Thomas P. Quinn, Jr., *Time to Rethink ESIGN "Consent Handshake" Standards?* (May 2014), https://www.counselorlibrary.com/insights/article.cfm?articleID=810.

[27] E-Sign Act section 101(c)(1); 15 U.S.C. § 7001(c)(1).

[28] Bureau of Consumer Fin. Protect., *Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z)*, 78 FED. REG. 10901, 10963 & n.118 (Feb. 14, 2013) ("The Bureau notes that TILA section 128(f) does not require a 'writing'; thus, the Bureau does not believe this provision triggers the E-Sign Act. . . . Additionally, the Bureau notes that TILA section 128(f)(2) requires the Bureau to take into account that statements may be transmitted electronically. This further suggests the periodic statement disclosure is not a 'writing' which would trigger the E-Sign Act requirements.").

[29] *Compare* 12 C.F.R. § 1026.5(a)(1)(iii) (open-end loans) *with* 12 C.F.R. § 1026.41(c) (closed-end loans).

[30] E-Sign Act section 7004(d)(1; 15 U.S.C. § 7004(d)(1) ("A Federal regulatory agency may, with respect to matter within its jurisdiction, by regulation or order issued after notice and an opportunity for public comment, exempt without condition a specified category or type of record from the requirements relating to consent in section 101(c) if such exemption is necessary to eliminate a substantial burden on electronic commerce and will not increase the material risk of harm to consumers.").

periodic statements, or change-in-terms notices.[31] Notably, the Bureau's recent debt collection rulemaking included a proposed E-Sign Act exemption for delivery of the debt-validation notice, but the Bureau chose not to finalize that provision after determining that it lacked sufficient information to properly assess the risk and benefits under the E-Sign Act's criteria.[32]

The above concerns—lengthy disclosures, outdated processes, inconsistent application across regulations, and limits on agencies' exemption authority—suggest that the E-Sign Act may have become a barrier to the type of innovation that Congress intended it to foster. Therefore, as discussed in Volume II of this Report, it may be time for Congress to amend the E-Sign Act, such as by eliminating certain requirements, replacing it with a more flexible approach, or granting agencies greater exemption authority.

9.2.2 Fair Debt Collection Practices Act (FDCPA)

As a second example, the FDCPA presents mixed issues for innovation. Unlike with the E-Sign Act, Congress had no stated goal of facilitating the use of new technology through the FDCPA; rather, Congress sought to end abusive collection practices.[33] The FDCPA thus consists largely of prohibitions as well as a handful of disclosure requirements to prevent deception or apprise consumers of their rights.

The FDCPA's principle-based rules remain as relevant today as they were when Congress passed it in 1977. Broad prohibitions on harassment or abuse, false or misleading representations, and unfair practices have been interpreted and applied to changes in market practices without the need to re-write the statute, similar to the Federal Trade Commission's (FTC's) experience with its authority for preventing unfair and deceptive acts and practices under the FTC Act. Likewise, the general prohibition on revealing debts to third parties can be applied to all collection practices, whether they are conducted in person, over the telephone, or through email. The same is true of many of the specific prohibitions, such as those against communicating with consumers who are represented by counsel or against falsely representing the amount of the debt or that the collector is affiliated with the government.

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[31] Bd. of Governors of the Fed. Reserve Sys., 72 Fed. Reg. 63445 (Regulation B) 63452 (Regulation E) 63456 (Regulation M), 63462 (Regulation Z), and 63477 (Regulation DD) (Nov. 9, 2007).

[32] Bureau of Consumer Fin. Protect., *Debt Collection Practices (Regulation F)*, __ FED. REG. __, Docket No. CFPB-2019-002, Oct. 30, 2020, at 432-42.

[33] FDCPA section 802; 15 USC 1692a(e) ("It is the purpose of this subchapter to eliminate abusive debt collection practices by debt collectors, to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged, and to promote consistent State action to protect consumers against debt collection abuses.").

On the other hand, many of the provisions about communicating with consumers have created uncertainty for consumers and debt collectors when applied to newer means of communications. Most notably, the FDCPA requires a debt collector communicating with a debtor to identify themselves as a debt collector or inform the debtor that the debt collector is attempting to collect a debt.[34] But a debt collector who discloses such information in a voicemail risks violating the FDCPA's separate prohibition against revealing debts to third parties if a third party overhears the message.[35] This conundrum has vexed courts, with some holding that debt collectors violated the FDCPA by omitting the required disclosure, while others have held that voicemails are not "communications" (and so not subject to the disclosure requirement) if they contain certain content,[36] and still others holding that no voicemail is completely immune from liability. Risk-averse collectors could simply choose not to leave them.[37]

The upshot is that many collectors did exactly that: They eschewed voicemails in favor of making repeated telephone calls to reach the debtor, contributing to the numerous consumer complaints about too-frequent telephone calls.[38] The Bureau has recently finalized a rule that would enable collectors to leave voicemails limited to specific content.[39]

Other FDCPA provisions show the difficulty of trying to apply-by-analogy rules governing older technologies. For example, the Bureau has confronted the question of whether and how a collector can use email to communicate with consumers. In its initial outline of proposals under consideration, the Bureau analogized an email to an envelope containing a letter, such that the outside of an email (the "from" and "subject" fields) would be subject to similar limitations on language as the outside of an envelope.[40] By the proposed rule stage, however, the Bureau

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34 FDCPA section 807(11); 15 U.S.C. § 1692e(11).

35 FDCPA section 805(b); 15 U.S.C. § 1692c(b). *See, e.g., Cordes v. Frederick J. Hanna & Assocs., P.C.*, 789 F. Supp. 2d 1173, 1177 (D. Minn. 2011); *Fed. Trade Comm'n v. Check Enforcement*, No. CIV.A. 03–2115 (JWB), 2005 WL 1677480, at *8 (D.N.J. July 18, 2005); *aff'd sub nom. Fed. Trade Comm'n v. Check Investors, Inc.*, 502 F.3d 159 (3d Cir. 2007).

36 *See, e.g., Zortman v. J.C. Christensen & Assocs., Inc.*, 870 F. Supp. 2d 694, 707-08 (D. Minn. 2012); *Biggs v. Credit Collections, Inc.*, No. CIV-07-0053-F, 2007 WL 4034997, at *4 (W.D. Okla. Nov. 15, 2007).

37 *See, e.g., Foti v. NCO Fin. Sys., Inc.*, 424 F. Supp. 2d 643, 655–50 (S.D.N.Y. 2006).

38 Bureau of Consumer Fin. Protect., *Debt Collection Practices (Regulation F)*, 84 FED. REG. 23274, 23290 (May 21, 2019).

39 Bureau of Consumer Fin. Protect., *Debt Collection Practices (Regulation F)*, __ FED. REG. __, Docket No. CFPB-2019-002, Oct. 30, 2020, at 565 (12 C.F.R. § 1006.2(j)).

40 Bureau of Consumer Fin. Prot., Small Business Review Panel for Debt Collector and Debt Buyer Rulemaking: Outline of Proposals Under Consideration and Alternatives Considered, at appendix H at 2 (July 2016), https://files.consumerfinance.gov/f/documents/20160727_cfpb_Outline_of_proposals.pdf ("[FDCPA] section 808(8) provides that, when a debt collector communicates with a consumer by mail or by telegram, the debt collector

appeared to analogize an email to the letter itself—that is, the password to access the email account functioned like the protections afforded to a consumer's postal mailbox, and an email sent to the correct address could contain all the same information as a letter addressed to the right consumer.[41] Thus we see the challenges that regulators face when attempting to stay true to outdated statutory language while also predicting what interpretation may achieve the best ends for consumers and market participants.

9.3 Regulatory Challenges and Non-Rulemaking Tools

As the above examples suggest, technology-enabled financial innovation presents a number of unique challenges for regulators. Financial regulators also need to consider how financial innovation interacts with regulatory objectives such as financial inclusion, financial stability, financial integrity, and consumer protection. First, regulators are usually not technology experts. Second, many FinTech companies are not traditional financial services providers, and so regulatory jurisdiction may not even be clear. Third, regulators often prefer products and services with known costs and benefits to those that present uncertainty for consumers and markets. Fourth, regulators have limited resources, and devoting time, staff, and finances to understanding new technologies can be significant. And fifth, incumbent institutions may pressure regulators to maintain the status quo by erecting express or de facto barriers to entry, such extending the existing regulatory regime to cover new products and services (raising rivals' entry costs or preventing entry altogether).[42]

In response, regulators have developed a number of strategies to foster the benefits of innovation while guarding against risks. One is to organize themselves internally to ensure an

may not use any language or symbol on the envelope other than the collector's address. The debt collector also may include his business name on the envelope, but only if the name does not indicate that he is in the debt collection business. The proposals under consideration would adapt these standards to newer technologies such as email by specifying that a debt collector cannot send an email message to a consumer if the message's 'from' or 'subject' lines contain information that would reveal that the email is about a debt.").

[41] Bureau of Consumer Fin. Protect., *Debt Collection Practices (Regulation F)*, 84 FED. REG. 23274, 23400-01 (proposed 12 C.F.R. § 1006.6(d)), 23406 (proposed 12 C.F.R. § 1006.42(b)) (May 21, 2019). Reflecting this change in approach, under one provision of the proposed rule, a collector could obtain a safe harbor by, among other things, disclosing the purpose of the communication in an email's "subject" field, an act that the outline of proposals under consideration would have *prohibited*. *Id.* at 23406 (proposed 12 C.F.R. § 1006.42(b)).

[42] United Nations Secretary-General's Special Advocate for Inclusive Finance for Development and Cambridge Centre for Alternative Finance, *Early Lessons on Regulatory Innovations to Enable Inclusive FinTech: Innovation Offices, Regulatory Sandboxes, and RegTech*, at 15 (2019), https://www.unsgsa.org/files/3515/5007/5518/UNSGSA_Report_2019_Final-compressed.pdf. [hereinafter "UNGSA, *Early Lessons*"].

innovation focus, such as by creating a dedicated office of innovation or a FinTech accelerator. Another is to employ new tools aimed at cooperation and mutual learning between market participants and regulators. Such tools include regulatory sandboxes, no-action letters, tech sprints, and formal and informal guidance. Next, we will explore these strategies primarily through the lens of the Bureau.

9.3.1 Office of Innovation

Numerous regulators in the U.S. and around the world have established offices of innovation.[43] Although they vary in precise form and function, an office of innovation generally engages with and provides regulatory clarity to companies that wish to offer innovative products and services. This engagement can be informal, such as office hours during which agency staff answer questions or make presentations.[44] It can also be more formal, such as through participation in a regulatory sandbox or similar initiative (discussed in the following subsections). Apart from the universal focus on innovation, these offices may differ in their specific objectives or criteria for engaging with a market participant. An office may limit its initiatives to products or providers that have the potential to promote financial inclusion, will serve the domestic market, or have ensured against risks to consumers.[45]

An office of innovation can benefit firms and regulators and consumers in various ways. FinTech companies, particularly those in the U.S., face high costs of regulatory uncertainty. By engaging with market participants, regulators can also hope to build a better understanding of new technologies and products as well as develop evidence for future policy decisions. Given that offices of innovation are still a relatively new phenomenon, however, their overall impact, including on financial inclusion, is an ongoing question and still difficult to discern completely.[46]

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[43] UNGSA, *Early Lessons* at 19 & figure 5 (identifying 33 countries that have at least one regulatory office of innovation).

[44] *See, e.g.*, Office of the Comptroller of the Currency, *OCC to Host Innovation Office Hours in Washington, D.C.* (Aug. 12, 2019), https://www.occ.treas.gov/news-issuances/news-releases/2019/nr-occ-2019-89.html; LabCFTC, Announcing LabCFTC Office Hours, https://www.cftc.gov/sites/default/files/2018-09/labcftc_officehours102318.pdf.

[45] UNGSA, *supra* note 42, at 21, figure 6.

[46] *Id.* at 21.

The Bureau established its Office of Innovation in 2018, folding into it the work of a predecessor endeavor.[47] The Office administers the Bureau's innovation policies, including the regulatory sandboxes, trial disclosure program, and no-action letter program, and in conjunction with other offices within the Bureau's it helped organize the Bureau's tech sprints. The Office estimates that it engages with over 100 firms per month regarding innovation issues through office hours (both scheduled and ad hoc) and other outreach.

9.3.2 Regulatory Sandboxes

Regulatory sandboxes have been "widely adopted" throughout the world as a way to promote innovation.[48] "[S]andboxes are, at their core, formal regulatory programs that allow market participants to test new financial services or business models with live customers, subject to certain safeguards and oversight."[49] A United Nations (U.N.) report observed that there are two distinct, overlapping models: (1) product testing sandboxes, which permit an institution to offer a new product that has not been registered or licensed; and (2) policy testing sandboxes, which enable a regulator to test a regulatory hypothesis on new technologies or business models.[50] Multi-jurisdictional sandboxes are a sort of third model; they may involve more than one regulatory entity and may adopt elements of either product or policy testing sandboxes.[51]

Sandboxes can promote consumer-protective innovation in several ways. By testing and closely observing new products, regulators can identify potential sources of consumer harm associated with innovation, suggest tweaks to the product or service, and obtain immediate feedback on whether the changes ameliorate potential harm or affect the product's benefits. By testing regulatory policy hypotheses, regulators may be able to learn whether a regulatory approach achieves particular policy goals before applying it to an entire industry.

Sandboxes can further promote innovation and financial inclusion by helping to identify areas of existing regulations that inadvertently inhibit the development of new products or services.[52] For example, the Bank Negara Malaysia amended its "know your customer" regulations after a

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[47] Press Release, *Bureau of Consumer Financial Protection Announces Director for the Office of Innovation* (July 18, 2018), https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-announces-director-office-innovation/.

[48] UNGSA, *supra* note 42, at 7.

[49] *Id.* at 26.

[50] *Id.* at 27.

[51] *Id.*

[52] UNGSA, *supra* note 42, at 30.

sandbox trial involving a remittance provider, WorldRemit. The regulations had required in-person checks, which created significant barriers to opening accounts online, particularly in rural areas. The sandbox trial allowed WorldRemit to operate its electronic know your customer tool under the Bank's supervision. The Bank and WorldRemit's customers were sufficiently satisfied by the electronic tool that the Bank amended its regulations.[53]

As of late 2020, the Bureau has two sandbox programs dedicated to innovation—a Compliance Assistance Sandbox (CAS) and a Trial Disclosure Sandbox.[54] To borrow the U.N. report's classifications, both appear to be primarily product testing sandboxes. The Bureau also participates in two multi-jurisdictional sandboxes.

CAS

In 2019, the Bureau established its CAS. It enables approved entities to test a new product or service for a limited period of time while under the Bureau's supervision.[55] Bureau approvals are "intended to facilitate compliance in the face of regulatory uncertainty."[56] An approved entity receives a safe harbor from liability under certain laws—which can include the TILA (Regulation Z), the Equal Credit Opportunity Act (ECOA) (Regulation B), and the Electronic Fund Transfer Act (EFTA) (Regulation E)[57]—thus precluding federal or state regulators from assessing liability for the product or service. Approvals are expected to last up to two years, unless renewed.[58]

During the approved period, the entity must report certain information to the Bureau so that the Bureau can monitor for any "material increase" in the risk of consumer injury. Such information includes "complaint patterns, default rates, or similar metrics."[59] If the reported information, or

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53 UNGSA, supra note 42, at 30; BNM (Bank Negara Malaysia), Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) – Money Services Business (Sector 3) (Supplementary Document No. 1), http://www.bnm.gov.my/index.php?ch=57&pg=146&ac=650&bb=file.

54 *See* Bureau of Consumer Fin. Protect., *Policy on the Compliance Assistance Sandbox*, 84 Fed. Reg. 48246 (Sept. 13, 2019); Bureau of Consumer Fin. Protect., *Policy To Encourage Trial Disclosure Programs*, 84 Fed. Reg. 48260 (Sept. 13, 2019); Bureau of Consumer Fin. Protect., *Innovation at the Bureau*, https://www.consumerfinance.gov/policy-compliance/innovation/. Prior to establishing the sandboxes, the Bureau promoted innovation through a program called Project Catalyst, which, among other things, included a trial disclosure program. https://www.consumerfinance.gov/about-us/blog/project-catalyst-collaboration-improve-understanding-financial-well-being/.

55 Bureau of Consumer Fin. Protect., *Policy on the Compliance Assistance Sandbox*, 84 FED. REG. 48246 (Sept. 13, 2019) [hereinafter "CFPB CAS Policy"].

56 CAS Policy, 84 FED. REG. at 42848.

57 The Bureau relies on 15 U.S.C. § 1640(f) (TILA); 15 U.S.C. § 1691e(e) (ECOA); and 15 U.S.C. § 1693m(d) (EFTA) as the authority for these safe harbors. *See* CFPB CAS Policy, 84 Fed. Reg. at 48256 n.66.

58 CFPB CAS Policy, 84 Fed. Reg. at 48247, § E.1.

59 Id., § D.5.

a change in applicable law (such as a statutory amendment or Supreme Court decision), suggests that the entity is not complying with the law or the terms of the Bureau's approval, the Bureau can terminate the approval or require the entity to change its program.[60]

The Bureau's CAS Policy also allows for the approvals of templates so that multiple entities can test identical products or services under the Bureau's supervision.[61] Under this option, a service provider, trade association, consumer advocacy group, or other third party who is not a covered person can apply for a template approval regarding a product or service. Subsequently, individual covered persons offering the same or substantially similar product or service can apply for the approval pursuant to the terms of the template. This option enables multiple covered persons to participate in a sandbox trial for the same product or service.

In determining whether to approve an applicant, the Bureau considers the potential consumer benefits and risks associated with the product or service as well as whether the applicant has identified metrics for evaluating the realization of those benefits and strategies to mitigate the risks.[62] The Bureau also requires applicants to identify the specific statutory or regulatory ambiguity giving rise to the entity's application, to provide an explanation why CAS approval is the appropriate way to resolve the ambiguity, and to describe how the product or service complies with applicable law.[63] To that extent, the Bureau has stated that CAS approvals are meant to address regulatory uncertainty, not to relieve entities from regulatory obligations.[64]

As of late 2020, the Bureau has approved one CAS template application, which was submitted by a service provider that intends to work with employers who wish to enroll employees in emergency savings plans.[65] The program would direct a percentage of employees' salaries into emergency savings products that the employees could access; employees could change the contribution amount or account-holding institution, or opt out of the program entirely, at any time. If employees do not designate an account for their savings, the employer would create an account for the employee at a designated institution and direct the employee's earnings under the program to that account. The Bureau found that a CAS template was appropriate because of

[60] Id., § E.3.

[61] Id., § F.

[62] CFPB CAS Policy, §§ B.3-.4, C. The Bureau expects to grant or deny applications generally within 60 days of receiving them. *Id.* at § C.

[63] Id., §§ B.5, C.

[64] CFPB CAS Policy, 84 FED. REG. at 42848 ("Approvals are intended to facilitate compliance in the face of regulatory uncertainty. The relief they provide is from regulatory uncertainty, not from regulatory obligation.").

[65] *See* Bureau of Consumer Fin. Protect., *Granted Applications*, https://www.consumerfinance.gov/policy-compliance/innovation/granted-applications/ (Build Commonwealth, Inc., Cast Template).

potential ambiguity under EFTA and Regulation E regarding autosave programs—in particular, Regulation E requires that employers give employees a choice how to receive their salary, but in cases where an employee does not make a choice, a question can arise about whether the employer has set a reasonable default enrollment method.[66] A CAS approval under this template would thus provide any approved employer with a safe harbor under those provisions of EFTA and Regulation E.

A consumer advocacy group, has criticized the CAS policy (and other Bureau innovation efforts) as exceeding the Bureau's authority, lacking public input, and employing insufficient procedural safeguards.[67] It contends that CAS approvals may amount to granting exemptions from—rather than merely addressing ambiguity in—legal requirements, which necessitates notice-and-comment rulemaking. They further object to the lack of public scrutiny: CAS applications are not public until the Bureau issues its decision, thereby precluding stakeholders from voicing concerns, and the CAS policy appears to contemplate that much of the data that the Bureau collects will remain confidential. The application process also elicits objections, with some claiming that the 60-day decision time and vague application and approval criteria will amount to the Bureau "rubber-stamping" applications. In short, critics fear that the Bureau will let industry members skirt the law without any accountability to the public or affected consumers, all in the name of innovation. The Taskforce notes these criticisms but believes that the potential benefits of the CAS identified in this section, combined with the fact that the Bureau considers the risks associated with specific CAS applications, outweigh risks identified by the advocacy group.

Trial Disclosure Sandbox

Through Section 1032(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress granted the Bureau express authority to provide certain legal protections to covered persons to conduct trial disclosure programs.[68] In particular, the Bureau may permit covered persons to conduct trial disclosure programs, limited in time and scope, for the purpose of providing trial disclosures designed to improve upon model forms within the Bureau's jurisdiction. The Bureau has had a trial disclosure policy in place since 2013, which it

[66] *Id.* (discussing 15 U.S.C. § 1693k(2), 12 C.F.R. § 1005.10(e)(2), and Comment 10(e)(2)-1).

[67] *See, e.g.,* Ams. For Fin. Reform Educ. Fund, *et al.*, *Comments on Policy on No-Action Letters and the BCFP Product Sandbox*, Docket No. CFPB-2018-0042 (Feb. 11, 2019), https://www.nclc.org/images/pdf/rulemaking/nclc-comments-nal-product-sandbox.pdf; Nat'l Consumer Law Ctr., *CFPB to Approve Potentially Risky Fintech Products* (Sept. 10, 2019), https://www.nclc.org/media-center/cfpb-to-approve-potentially-risky-fintech-products.html.

[68] 12 U.S.C. § 5532(e).

revised substantially in 2019, though it has yet to approve an application under either policy.[69] The revised policy employs largely the same application criteria and process as the CAS policy discussed above.

In its revised policy, the Bureau states that trial disclosures could be used where an entity wishes to test either an alternative to existing model form or a new form in the absence of an existing model.[70] Thus, the Bureau can use information from a trial program either to improve upon existing forms or to inform the creation of new model or sample forms. And during a trial program, the Bureau can work with the participating entity to make iterative improvements to the disclosure, thereby testing the effects of each change in a closely monitored environment.

Multi-Jurisdictional Sandboxes

Multi-jurisdictional sandboxes enable regulators to collaborate across borders and share experiences, including in ways that promote innovation in new technologies and practices.[71] They can also offer economies of scale to multiple regulators operating the sandbox together, though initial start-up costs and coordination may be challenging.[72] For financial entities, they offer the opportunity to testing products or strategies in multiple states or countries at once.[73]

The Bureau participates in two multi-jurisdictional sandboxes. The first, the American Consumer Financial Innovation Network (ACFIN), is open to state attorneys general, state financial regulators, and federal financial regulators within the U.S.[74] Launched in September 2019, it grew within a year to at least 19 members, including the Bureau, the Office of the Comptroller of the Currency (OCC), 10 state attorneys general, and seven state regulators.[75] ACFIN's stated purpose is "to facilitate innovation that benefits consumers through greater competition, consumer access, or financial inclusion in markets for consumer financial products

69 Bureau of Consumer Fin. Protect., *Policy To Encourage Trial Disclosure Programs; Information Collection*, 78 FED. REG. 64389 (Oct. 29, 2013); Bureau of Consumer Fin. Protect., *Policy To Encourage Trial Disclosure Programs*, 84 FED. REG. 48260 (Sept. 13, 2019) [hereinafter "CFPB 2019 Trial Disclosure Policy"].

70 CFPB 2019 Trial Disclosure Policy, 84 FED. REG. at 48261 n.4.

71 *See* Fin. Conduct Auth., *Global Financial Innovation Network (GFIN)*, https://www.fca.org.uk/firms/innovation/global-financial-innovation-network.

72 UNGSA, *supra* note 42, at 28.

73 *See* Fin. Conduct Auth., *Global Financial Innovation Network (GFIN)*, https://www.fca.org.uk/firms/innovation/global-financial-innovation-network.

74 Am. Consumer Fin. Innovation Network, *Charter as of October 15, 2019*, https://files.consumerfinance.gov/f/documents/201910_cfpb_ACFIN-charter.pdf.

75 Bureau of Consumer Fin. Protect., *American Consumer Financial Innovation Network*, https://www.consumerfinance.gov/policy-compliance/innovation/american-consumer-financial-innovation-network/.

and services."[76] It attempts to achieve this goal through members participating in joint office hours, no-action letter programs, or sandbox programs. To that end, the Bureau and the OCC have held joint office hours in which participants engaged in one-on-one meetings to discuss FinTech, new products or services, or other issues related to innovation.[77] With respect to no-action letter and sandbox programs, ACFIN encourages members to adopt similar application and approval processes, coordinate review of applications, and establish procedures for mutual recognition of no-action letters and sandbox trials.[78]

The Bureau also participates in the Global Financial Innovation Network (GFIN), one of the two international sandboxes.[79] A group of financial regulators and related organizations established GFIN in January 2019. It currently has more than 60 members, with the U.K.'s Financial Conduct Authority serving as chair.[80] GFIN's purpose is to enable regulators to collaborate and share experiences regarding innovation, to provide firms with accessible regulatory contacts, and to enable firms to conduct cross-border trials of products or services.[81] Given its infancy, GFIN has not yet approved any cross-border trials. It has initiated a cross-border testing pilot, in response to which GFIN received over 40 applications and identified eight candidates for potential participation in the pilot.[82]

9.3.3 No-Action Letters

A no-action letter is generally understood to be an agency's notification that it does not intend to recommend an enforcement or supervisory action against an entity based on the entity's

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[76] Am. Consumer Fin. Innovation Network, *Charter as of October 15, 2019*, https://files.consumerfinance.gov/f/documents/201910_cfpb_ACFIN-charter.pdf.

[77] Bureau of Consumer Fin. Protect., *CFPB, OCC Host Virtual Innovation Office Hours* (July 2, 2020), https://www.consumerfinance.gov/about-us/newsroom/cfpb-occ-host-virtual-innovation-office-hours/.

[78] Am. Consumer Fin. Innovation Network, *Charter as of October 15, 2019*, https://files.consumerfinance.gov/f/documents/201910_cfpb_ACFIN-charter.pdf.

[79] UNGSA, *supra* note 42, at 28. The other is API Exchange (APIX), launched by the ASEAN Financial Innovation Network in 2019. "APIX is a cross-border, open-architecture platform to improve financial inclusion. APIX enables financial institutions and FinTech firms to connect through a cross-border marketplace, conduct collaborative experiments in a sandbox among financial industry participants, and facilitate adoption of APIs to drive digital transformation and financial inclusion across the Asia Pacific region." *Id.*

[80] Global Fin. Innovation Network, https://www.thegfin.com/.

[81] Fin. Conduct Auth., *Global Financial Innovation Network (GFIN)*, https://www.fca.org.uk/firms/innovation/global-financial-innovation-network.

[82] Global Fin. Innovation Network, *Cross-border Testing*, https://www.thegfin.com/crossborder-testing.

description of a proposed transaction, product, or service.[83] Although its legal status can vary or be subject to considerable debate, a traditional no-action letter is not a legal conclusion that binds the agency.[84] Rather, it is agency staff's statement about the likelihood of enforcement or supervisory action, and it is limited to the facts as the entity presents them.[85]

No-action letters have a considerable history in U.S. financial regulation. As early as 1936, the Securities and Exchange Commission (SEC) issued "opinions of counsel," the precursor to modern no-action letters. These consisted of staff opinions on the applicability of laws to particular transactions or the likelihood of enforcement, contained the caveat that they were not SEC rulings, and generally remained non-public.[86] By the early 1960s, no-action letters largely replaced opinions of counsel, and today they are issued and made public pursuant to established SEC policies.[87] By some estimates, the SEC has issued over 2,500 no-action letters in the last 50 years.[88] The Commodity Futures Trading Commission (CFTC) has likewise made extensive use of no-action letters, issuing at least an estimated 1,500 since 1975.[89] Similar to the SEC's

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83 Bureau of Consumer Fin. Protect., *Policy on No-Action Letters; Information Collection*, 81 FED. REG. 8686, 8692 (Feb. 22, 2016) [hereinafter "CFPB 2016 NAL Policy"]; ("[A]n agency may provide some form of notification that it does not intend to recommend initiation of an enforcement or supervisory action against an entity based on the application of specific identified provisions of statutes or regulations to its offering of a particular product."); Sec. & Exch. Comm'n, *Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice*, Securities Act Release No. 6253, 21 S.E.C. Docket 320 n.2 (Oct. 28, 1980) ("A no-action letter is one in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated."); 17 C.F.R. § 140.99(a)(2) (similar definition in CFTC regulations).

84 See, e.g., Donna M. Nagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework, 83 CORNELL L. REV. 921, 937-38 (1998).

85 *See, e.g.*, 17 C.F.R. § 140.99(a)(2) ("*No-action letter* means a written statement issued by the staff of a Division of the Commission or of the Office of the General Counsel that it will not recommend enforcement action to the Commission for failure to comply with a specific provision of the Act or of a Commission rule, regulation or order if a proposed transaction is completed or a proposed activity is conducted by the Beneficiary. A no-action letter represents the position only of the Division that issued it, or the Office of the General Counsel if issued thereby. A no-action letter binds only the issuing Division or the Office of the General Counsel, as applicable, and not the Commission or other Commission staff. Only the Beneficiary may rely upon the no-action letter.").

86 *See* Nagy, 83 CORNELL L. REV. at 936-37 (citing Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1019, 1021 (1987); Louis Loss & Joel Seligman, *Securities Regulation* 533-34 n.29 (3d ed. 1989)).

87 See Sec. & Exch. Comm'n, Procedure Applicable to Requests for No Action or Interpretative Letters, Securities Act Release No. 5127, 36 FED. REG. 2600 (Jan. 25, 1971); Sec. & Exch. Comm'n, Procedures Applicable to Requests for No-Action and Interpretive Letters, Securities Act Release No. 33-6523, 45 FED. REG. 72644 (Oct. 28, 1980); SEC. & EXCH. COMM'N, Procedures Applicable to Requests for No-Action and Interpretive Letters, Securities Act Release No. 6269 (Dec. 23, 1980), https://www.sec.gov/rules/other/33-6269.pdf; 17 C.F.R. 200.81 (describing procedures applicable to publication of interpretive, no-action, and certain exemption letters).

88 Bureau of Consumer Fin. Protect., *Policy on No-Action Letters*, 84 FED. REG. 48229, 48244 n.56 (Sept. 13, 2019) [hereinafter "CFPB 2019 NAL Policy"].

89 CFPB 2019 NAL Policy, 84 FED. REG. at 48244 n.56 (summarizing review no-action letters listed on CFTC website).

practice, CFTC no-action letters are styled as staff statements about whether it will recommend enforcement with respect to a proposed transaction or activity.[90]

No-action letters have significant benefits and drawbacks for agencies, industry, and consumers. For industry members, they provide reasonable assurance that a transaction or practice will not lead to an enforcement action, reducing the firm's risk of liability and therefore encouraging it to offer new products or services. Although a no-action letter may apply only to the particular entity that requested it, other firms who wish to offer the same or similar product may factor it into their risk analysis. The informal nature of a no-action letter also allows a regulator to issue them much more quickly than a notice-and-comment rulemaking. As a result, consumers may benefit from the introduction of new products or services that otherwise might be delayed pending regulatory clarity.

The informal nature of no-action letters also leads to some of their primary criticisms. While styled as staff statements, industry and sometimes courts can treat no-action letters as authoritative statements of law. Commentators have described SEC no-action letters as "a source of de facto law"[91] and "the sole body of precedent" on some aspects of securities law.[92] Issued without with the opportunity for public input, however, agencies risk acting without full consideration of all potential arguments or facts beyond those that the requesting entity chooses to disclose. Consumer advocacy groups have expressed concern that certain no-action letters could amount to de facto legislative rules done without notice and comment, as they may change how consumer protection laws apply.[93] And while an agency could in theory simply withdraw a no-action letter at any time and take a different view of the law, it may be reluctant to do so given fair notice concerns and the reliance that parties have placed on the prior letter.

No-action letters also can be a considerable drain on agency resources. Reviewing, researching, and determining whether and how to respond to a request for a no-action letter can require a significant investment of time for agency staff—time that otherwise could be used to investigate or supervise potential law violators, engage in formal rulemaking that applies to an entire

[90] 17 C.F.R. § 140.99(a)(2).

[91] Nagy, 83 CORNELL L. REV. at 925.

[92] Nagy, 83 Cornell L. Rev. at 924 (quoting Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1019 (1987)). The SEC itself recognizes that the public sometimes view no-action letters as "'the most comprehensive secondary source on the application of [the federal securities] laws.'" *Id.* (quoting Sec. & Exch. Comm'n, *Expedited Publication of Interpretative, No-Action and Certain Exemption Letters*, Securities Act Release No. 6764, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P84,228, at 89,053, 89,054 (Apr. 7, 1988)] Fed. Sec. L. Rep. (CCH) ¶ 84,228, at 89,053, 89,054 (Apr. 7, 1988).

[93] CFPB 2019 NAL Policy, 84 FED. REG. at 48231 (summarizing comments to the Bureau's proposed no-action letter policy).

market, or provide less resource-intensive oral guidance. To that end, the SEC greatly simplified its no-action letter process in 1980, switching from a model in which staff drafted a summary of the pertinent facts and agency views to an "endorsement method" in which it publishes the industry member's request and adds a short statement at the end expressing staff's view.[94] In addition, neither the SEC nor the CFTC has a set time period in which staff will respond to requests for no-action letters, and neither will address hypothetical scenarios.[95]

The Bureau established a no-action letter policy in 2016 and revised it substantially in 2019.[96] Both policies stated that their primary purpose was to promote innovation by reducing regulatory uncertainty as to the use of new technologies or products.[97] The revised no-action letter policy generally has the same application criteria and procedures as the compliance-assistance and trial-disclosure sandboxes discussed above, including for a third party to request a template no-action letter and the expected 60-day decision window for the Bureau.[98]

A Bureau no-action letter differs from a sandbox trial in three key respects. First, a no-action letter does not offer a safe harbor from liability or preclude state or other federal regulators from asserting law violations. Instead, the letter is a statement that "the Bureau will not make supervisory findings or bring a supervisory or enforcement action against the recipient" predicated on the facts described in the application.[99] Second, unlike the expected two-year terms for sandbox trials, no-action letters are no limited to a two year term.[100] And third, no-action letters do not require the recipient to share data with the Bureau on an ongoing basis.

As of late 2020 the Bureau has issued six no-action letters.[101] The first, issued under the Bureau's original 2016 policy, concerned a company that uses alternative data and machine

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[94] Sec. & Exch. Comm'n, *Procedures Applicable to Requests for No-Action and Interpretive Letters*, Securities Act Release No. 33-6523, 45 FED. REG. 72644 (Oct. 28, 1980).

[95] Sec. & Exch. Comm'n, *Procedures Applicable to Requests for No-Action and Interpretive Letters*, Securities Act Release No. 33-6523, 45 FED. REG. 72644 (Oct. 28, 1980); 17 C.F.R. § 140.99(b)(5)(ii).

[96] *See generally* CFPB 2016 NAL Policy, 81 FED. REG. 8686; CFPB 2019 NAL Policy, 84 Fed. Reg. 48229. While the original policy anticipated that the Bureau would issue no-action letters sparingly (one to three per year), be unlikely to address the DFA's UDAAP provisions, and likely require the recipient to share data with the Bureau, the current policy is more flexible and has no such limitations or data-sharing requirements.

[97] CFPB 2016 NAL Policy, 81 FED. REG. at 8688; CFPB 2019 NAL Policy, 84 FED. REG. at 48229.

[98] Id., §§ B, C, and E.

[99] Id., § C.3.

[100] Id., § D.

[101] Bureau of Consumer Fin. Protect., *Granted Applications*, https://www.consumerfinance.gov/policy-compliance/innovation/granted-applications/ (listing approvals for Upstart Network, Inc.; U.S. Department of Housing and Urban Development (HUD) (on behalf of HUD-approved housing counselors); Bank of America, N.A.; Brace Software, Inc.; and Bank Policy Institute).

learning in making credit underwriting and pricing decisions. The company reported that using an machine learning underwriting model that incorporated alternative data resulted in substantially more approved applications, and substantially lower APRs, than its traditional model.[102] Three other no-action letters concerned applications for template approvals, including one from a service provider that offers loss-mitigation software to mortgage servicers, another from a trade association on behalf of depository institutions that may offer a standardized small-dollar credit product, and one from the Department of Housing and Urban Development (HUD) on behalf of housing counselors.

Some aspects of the Bureau's policy remain worth monitoring, however. For example, the expectation that the Bureau will approve or deny an application within 60 days (whereas the SEC and CFTC policy have no explicit timing parameters) may create the perception that the Bureau is acting without fully considering the potential effects of an approval (although the Bureau encourages potential applications to contact the Bureau before submitting an application so that the parties can discuss potential pitfalls, and it appears that applicants have followed this suggestion). In addition, because the Bureau's Office of Innovation—rather than its rule writing, supervisory, or enforcement offices—issues the no-action letters, the Bureau will need to carefully coordinate internally so that any approvals represent a consensus staff view. And, as discussed more below, the Bureau will need to consider carefully which issues are appropriate for a no-action letter and which would benefit from public input.

9.3.4 Advisory Opinions

Advisory opinions generally articulate an agency's interpretation of a statute or regulation. They range in formality and legal effect across agencies—some are essentially no-action letters that provide non-binding staff opinions regarding a particular person's conduct in a specific scenario, while others are formal interpretive rules that bind the agency and all covered persons.[103] In all forms, advisory opinions may promote innovation by giving institutions assurance regarding whether novel practices comply with the law.

The Bureau recently announced an advisory opinion pilot program, which includes among its stated goals to ensure that consumer financial services markets operate transparently and

[102] Bureau of Consumer Fin. Protect., *An Update on Credit Access and the Bureau's First No-Action Letter* (Aug. 6, 2019), https://www.consumerfinance.gov/about-us/blog/update-credit-access-and-no-action-letter/.

[103] *See, e.g.*, U.S. Fed. Deposit, Ins. Corp., *FDIC Law, Regulations, Related Acts*, https://www.fdic.gov/regulations/laws/rules/4000-50.html (last updated Apr. 20, 2014); U.S. Dep't of Labor, *Filing Requests for ERISA Advisory Opinions: ERISA Procedure 76-1*, https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/filing-requests-for-erisa-aos [https://perma.cc/UW53-4LDJ]; U.S. Fed. Elec. Comm'n, *The Advisory Opinion Process*, https://www.fec.gov/legal-resources/advisory-opinions-process/.

efficiently to facilitate access and innovation.[104] The advisory opinions will be interpretive rules under the Administrative Procedures Act; as such, they will bind the agency and apply equally to any similarly situated person. To that end, fact-intensive issues, such as determinations regarding unfair, deceptive, or abusive acts or practices (UDAAPs) or discrimination, are likely not ripe for an advisory opinion. Critics of the advisory program are concerned that the process lacks sufficient public input and scrutiny, particularly with respect to the lack of an opportunity to comment on prospective interpretive rules.

9.3.5 Tech Sprints

A financial "tech sprint" brings together participants representing regulators, financial institutions, service providers, technology experts, and others to develop technology-based ideas to address a specific topic or challenge.[105] The U.K.'s Financial Conduct Authority (FCA) pioneered the use of tech sprints in consumer finance, hosting at least seven since 2016.[106] Adapted from so-called "hackathons" that had become increasingly popular in other areas, FCA tech sprints assign participants from different organizations to work collaboratively in small teams.[107] FCA identifies a specific regulatory compliance or market problem that the teams attempt to solve using modern technology, such as application programming interfaces (APIs) or machine learning programs. Tech sprints typically last two days (and up to two weeks). On the last day, teams present their solutions to a panel of judges, which selects a winner. Topics have included consumer access, regulatory reporting, and financial services and mental health.[108]

FCA has identified a number of general and specific ways that tech sprints promote innovation. At a general level, they (1) offer a learning opportunity for regulators, market participants, and others on the use of newer technologies; (2) signal regulatory interest on a topic that may

[104] Bureau of Consumer Fin. Protect., *Advisory Opinions Pilot*, 85 FED. REG. 37331, 37332-33 (June 22, 2020).

[105] Bureau of Consumer Fin. Protect., *Request for Information Regarding Tech Sprints*, 84 FED. REG. 49099, 49100 (Sept. 19, 2019); UNGSA, *supra* note 42, at 37; Fin. Conduct Auth., *TechSprints* (last updated Mar. 3, 2020), https://www.fca.org.uk/firms/innovation/regtech/techsprints.

[106] Fin. Conduct Auth., *Fostering Innovation Through Collaboration: The Evolution of the FCA TechSprint Approach*, at § 2.9 (Mar. 2020), https://www.fca.org.uk/publication/research/fostering-innovation-through-collaboration-evolution-techsprint-approach.pdf [hereinafter, "FCA TechSprint Report"].

[107] Id., at § 2.2.

[108] Id., at § 2.8; Fin. Conduct Auth., *TechSprints* (last updated Mar. 3, 2020), https://www.fca.org.uk/firms/innovation/regtech/techsprints. As a more specific example, the consumer access tech sprint "focused on developing practical outcomes using API-accessible data to help overcome consumer access issues to appropriate financial services. Participants had access to the largest anonymi[z]ed customer data test bed in Europe." Fin. Conduct Auth., *Consumer Access TechSprint*, https://www.fca.org.uk/events/techsprints/consumer-access-techsprint.

require industry-wide collaboration to address successfully; (3) increase regulatory, academic, and market focus on a technology or issue; (4) foster long-lasting relationships between participants that can cross borders and industries; and (5) generate prototype solutions that can be modified and scaled for use in the market.[109]

Among examples of tangible outcomes, private firms are exploring three of the ideas generated during FCA's first tech sprint as products to potentially bring to market.[110] In addition, through two tech sprints on regulatory reporting, participants developed a prototype computer program that could automate certain regulatory reporting obligations of a financial institution's. This prototype spurred a pilot program on digital regulatory reporting funded by private firms, the FCA, and the Bank of England.[111] FCA's tech sprints have also led to literature contributions.[112]

In the U.S., agencies that are not financial regulators such as the Census Bureau and the Department of Health and Human Services (HHS) have used tech sprints. The Census Bureau established "The Opportunity Project," which facilitates 12-week tech sprints focused on helping companies, non-profit organizations, and universities build products with federal open data that help solve national challenges.[113] Multiple products that participants developed are now available for public use.[114] Following this model, HHS and the Presidential Innovation Fellows organized a 14-week tech sprint that likewise focused on applying digital tools, in this case AI, to federal open data.

Citing FCA, the Census Bureau, and HHS as influential precedents,[115] the Bureau held its first tech sprint in October 2020.[116] Participants worked in teams to develop and test innovative approaches to the electronic delivery of adverse action notices required under ECOA and the

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109 Id., at § 2.11.

110 Fin. Conduct Auth., *Consumer Access TechSprint*, https://www.fca.org.uk/events/techsprints/consumer-access-techsprint.

111 Fin. Conduct Auth., *Digital Regulatory Reporting* (last updated Sept. 7, 2020), https://www.fca.org.uk/innovation/regtech/digital-regulatory-reporting.

112 Andrew Bart, *et al.*, *Model Driven and Machine Executable Regulations Tech Sprint: Success Criteria & Recommendations* (undated), https://www.immuta.com/model-driven-and-machine-executable-regulations-tech-sprint/.

113 Opportunity Project, *Our Process*, https://opportunity.census.gov/our-process/.

114 Opportunity Project, *Products*, https://opportunity.census.gov/showcase/.

115 Bureau of Consumer Fin. Protect., *Request for Information Regarding Tech Sprints*, 84 FED. REG. 49099, 49100 (Sept. 19, 2019).

116 Bureau of Consumer Fin. Protect., *CFPB Tech Sprints*, https://www.consumerfinance.gov/policy-compliance/innovation/cfpb-tech-sprints/.

Fair Credit Reporting Act (FCRA).[117] The Bureau noted that, following the tech sprint, participants might consider testing their alternative disclosures through the Bureau's Trial Disclosure Sandbox.[118] The Bureau has also announced plans to hold future tech sprints.[119]

9.3.6 Other Formal and Informal Guidance

As discussed in Chapter 6, agencies provide non-binding guidance in numerous forms, including one-off oral guidance, answers to frequently asked questions, webinars, examination manuals, compliance guides, and policy statements.[120] Agencies have used these methods to promote innovation, with notable examples including the Bureau's policy statement on data sharing[121] and an interagency guidance on the use of alternative data and AI,[122] and a blog post on providing adverse action notices when using AI/machine learning models.[123] Although not binding interpretations of law, such statements can articulate an agency's preferred objectives and signal to market participants what activities are more or less likely to invite regulatory scrutiny.

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117 Bureau of Consumer Fin. Protect., *Electronic Disclosure of Adverse Action Virtual Tech Sprint*, https://www.consumerfinance.gov/policy-compliance/innovation/cfpb-tech-sprints/electronic-disclosures-tech-sprint/.

118 Id.

119 Bureau of Consumer Fin. Protect., *CFPB Tech Sprints*, https://www.consumerfinance.gov/policy-compliance/innovation/cfpb-tech-sprints/.

120 *See, e.g.*, Bureau of Consumer Fin. Protect., *Request for Information Regarding Bureau Guidance and Implementation Support*, 83 FED. REG. 13959 (Apr. 2018) (summarizing and requesting comment on the Bureau's various guidance and implementation practices); Bureau of Consumer Fin. Protect., *Submit a Regulatory Inquiry*, https://reginquiries.consumerfinance.gov/ (providing instructions and a fillable form for submitting a regulatory inquiry to the Bureau).

121 Bureau of Consumer Fin. Protect., *Consumer Protection Principles: Consumer-Authorized Financial Data Sharing and Aggregation* (Oct. 18, 2017), https://files.consumerfinance.gov/f/documents/cfpb_consumer-protection-principles_data-aggregation.pdf.

122 *Interagency Statement on the Use of Alternative Data in Credit Underwriting* (Dec. 2019), https://files.consumerfinance.gov/f/documents/cfpb_interagency-statement_alternative-data.pdf.

123 https://www.consumerfinance.gov/about-us/blog/innovation-spotlight-providing-adverse-action-notices-when-using-ai-ml-models/.

9.4 Trends in Innovation

9.4.1 Advances in Technology

As noted at the outset of this chapter, innovation in financial services today is almost synonymous with technology-enable financial services, or "FinTech." In a 2018 report, the Department of the Treasury identified three broad trends that undergird FinTech innovation in financial services: increased digital access; growth in the types and quantity of available consumer data; and development of AI, including machine learning.[124] These developments are intertwined and feed into one another. Greater digital access, for example, leads to the accumulation of more consumer data in a digital format that is easier to manipulate; AI-backed programs can analyze this data more quickly and evolve to become more accurate; and, in turn, these programs can feed into new or improved consumer products and services offered on digital devices. This subsection summarizes some of the broad advances in these key areas, and the next subsection discusses the development of particular products and services.

Digital Access

The rise of digital devices, such as personal computers, tablets, smart phones, and other mobile devices, is at the core of FinTech's rapid growth. Approximately 90 percent of U.S. adults have regular internet access. Eighty percent own a smart phone that can operate advanced applications, 74 percent own a laptop or desktop computer, and over 50 percent own a tablet. Most adults communicate using some combination of telephone calls, text messages, and emails to manage their business and personal relationships.[125]

Both traditional financial institutions (such as banks) and upstart FinTech firms have responded to the rise of digital technology by greatly expanding their products and services on digital platforms. Consumers are rapidly adopting these new services. Over 50 percent of consumers with bank accounts engage in online banking, up from 20 percent from a decade ago.[126] A survey conducted in 2019 found that almost half of U.S. consumers with regular internet access, and almost two-thirds of such consumers world-wide, use at least some FinTech services, such as

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[124] U.S. Dep't of the Treasury, A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation (July 2018) [hereinafter "Treasury FinTech Report."].

[125] Id., at 17 (internal citations omitted).

[126] *Id.* (citing Ellen A. Merry (Bd. of Governors of the Fed. Reserve Sys.), *Mobile Banking: A Closer Look at Survey Measures* (Mar. 27, 2018), https://doi.org/10.17016/2380-7172.2163.).

financial planning, savings and investment, online borrowing, or some form of money transfer and payment.[127]

Although digital access has expanded rapidly, it has not reached all consumers. Known as the "digital divide," there is a significant "gap between populations that have access to modern information and communication technology and those that have no or limited access."[128] The FCC estimates 30 percent of consumers living in rural America—roughly 24 million—lack access to broadband (as compared to 2.1 percent of consumers in urban areas).[129] Digital access rates also vary by race, age, income, and educational background. For example, consumers earning under $30,000 per year and those over age 65 have significantly lower rates of internet use, home-broadband access, and smartphone ownership than do other income and age groups.[130]

Data Aggregation

By the late 1990s, firms began to offer services that relied on data gathered across all of a consumer's financial accounts. Initially, banks and other traditional account holders were the primary users of such account data, but eventually new firms entered the market and began offering services that used this data.[131] Some of these service providers use their own technology to access and gather the data, while others hire third parties to obtain the data.[132]

Due to the rise in digital access, huge quantities and varieties of data now exist in digital form. These include both traditional data that furnishers have long furnished to consumer reporting agencies—on-time and delinquent payments, credit limits, and account balances—but also almost limitless other types of information about consumers' finances or consumers themselves. Such data can include bank account transaction data, utility and rental payments, purchases and use of individual products or services (*e.g.*, a smartphone), and information about the consumer's location. Online and mobile applications use this data to provide services such as

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[127] Ernst & Young Global Ltd., *Global FinTech Adoption Index 2019*, at 7 & figure 1 (2019), https://www.ey.com/en_gl/financial-services/eight-ways-fintech-adoption-remains-on-the-rise.

[128] Treasury FinTech Report, *supra* note 124, at 21-22.

[129] *Id.* (citing Fed. Commc'ns Comm'n, *2018 Broadband Deployment Report* (Feb. 2, 2018), https://apps.fcc.gov/edocs_public/attachmatch/FCC-18-10A1.pdf.).

[130] Pew Research Ctr., *Internet/Broadband Fact Sheet* (June 12, 2019), https://www.pewresearch.org/internet/fact-sheet/internet-broadband/; PEW RESEARCH CTR., *Mobile Fact Sheet* (June 12, 2019), https://www.pewresearch.org/internet/fact-sheet/mobile/.

[131] CFPB Data Sharing RFI, 81 FED. REG. 83806, 83808-09. In 2001, the OCC first issued guidance to depository institutions using third-party data aggregators. *See* Office of the Comptroller of Currency, OCC Bulletin 2001-12, *Bank-Provided Account Aggregation* Services (Feb. 28, 2001), https://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-12.html#.

[132] CFPB Data Sharing RFI, 81 Fed. Reg. 83806, 83808-09.

payments and fund transfers, financial advice regarding services or investments, and credit granting. Financial services providers also use this data in complex underwriting decisions and to enhance security.

"Data aggregators" are central to this growth in FinTech services. A data aggregator is a company that accesses a consumer's account data with the consumer's permission and uses the data to provide services directly or indirectly to the consumer.[133] The gathered information can come from many different sources and can range from publicly available information to personal account information, such as data about the consumer's credit-card, brokerage, and bank accounts.[134] A data aggregator may compile this information and present it in a consolidated format to the consumer or, more commonly, transfer it to another company that provides services to the consumer.[135]

Depending on one's definition of data aggregator, there may be at least 120 or as few as a handful of firms that engage in this activity. Vermont law requires parties that buy or sell third-party data to register with the secretary of state. As of March 2019, 121 firms had registered.[136] This total includes some entities—such as the National Student Clearinghouse and the nationwide consumer reporting agencies—that one would typically not think of as a data aggregator in the consumer finance market, even though they do gather and provide consumer

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[133] Bureau of Consumer Fin. Protect., *Consumer Protection Principles: Consumer-Authorized Financial Data Sharing and Aggregation* (Oct. 18, 2017), https://files.consumerfinance.gov/f/documents/cfpb_consumer-protection-principles_data-aggregation.pdf [hereinafter "CFPB Data Sharing Principles"].

[134] OCC, *Bank-Provided Account Aggregation Services: Guidance to Banks*, OCC BULLETIN 2001-12 (Feb. 28, 2001), https://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-12.html; Lael Brainard, *Where Do Consumers Fit in the Fintech Stack?*, (Remarks at *FinTech Risks and Opportunities: An Interdisciplinary Approach*) (Ann Arbor, Michigan, Nov. 16, 2017).

[135] OCC, *Bank-Provided Account Aggregation Services: Guidance to Banks*, OCC BULLETIN 2001-12 (Feb. 28, 2001), https://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-12.html; Lael Brainard, *Where Do Consumers Fit in the Fintech Stack?*, (Remarks at *FinTech Risks and Opportunities: An Interdisciplinary Approach*) (Ann Arbor, Michigan, Nov. 16, 2017), https://www.federalreserve.gov/newsevents/speech/brainard20171116a.htm (citing Envestnet Yodlee, *Envestnet Yodlee Unveils Personal Financial Wellness Solution Powered by Data Intelligence*, news release, June 12, 2017, www.prnewswire.com/news-releases/envestnet--yodlee-unveils-personal-financial-wellness-solution-powered-by-data-intelligence-300472018.htm).

[136] *See* Fast Company, *Here are the Data Brokers Quietly Buying and Selling your Personal Information*, Mar. 2, 2019, https://www.fastcompany.com/90310803/here-are-the-data-brokers-quietly-buying-and-selling-your-personal-information (listing and describing each of the registered firms); Fast Company, *A Landmark Vermont Law Nudges over 120 Data Brokers out of the Shadows*, Mar. 2, 2019, https://www.fastcompany.com/90302036/over-120-data-brokers-inch-out-of-the-shadows-under-landmark-vermont-law.

data. Focusing more narrowly on financial data aggregators, others estimate that there are as few as six significant firms in the market.[137]

In recent years, data aggregators have signed data access agreements with many of the largest banks, allowing them to transition from credential-based data access to API-based access. These agreements often address issues such as liability and consumer control of data. And because APIs give banks greater confidence about the data shared with third parties, some institutions are providing their customers with greater information about the sharing. For example, Chase's website allows consumers to see (i) the financial apps that are accessing their accounts through Chase's API, (ii) the specific accounts being accessed, (iii) the specific account information being accessed, and (iv) the last time it was accessed. Chase's service also enables customers to turn off account access for particular applications or entirely.[138] More broadly, some consortiums of market participants, as well as foreign jurisdictions, have developed industry standards and best practices for sharing data.[139]

Developers of financial apps often obtain consumers' data from data aggregators in order to provide mobile or other electronic services to consumers. Data aggregators often act as the intermediary between, on the one hand, the financial institutions that maintain consumers' accounts and thus have account-level data (*e.g.*, banks maintaining checking accounts) and, on the other hand, developers of financial apps that use such account-level data to provide services directly to the consumer. In this role, data aggregators facilitate financial services such as financial advice and management, lending, underwriting and security tools, among others. By providing continually updated data about consumers, data aggregators enable developers of financial apps to offer time-sensitive services, such as creating alerts for potential overdraft charges or more accurate assessments of creditworthiness.

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137 MX Techs. Inc., *A List of Financial Data Aggregators in the United States* (Mar. 5, 2018), https://www.mx.com/moneysummit/a-list-of-financial-data-aggregators-in-the-united-states (listing seven financial data aggregators, two of which (Plaid and Quovo) have since merged, and noting that Intuit stopped offering its account aggregation services to third parties in 2016); Tearsheet, *A Buyer's Guide to Data Aggregation* (Feb. 19, 2019), https://tearsheet.co/data/a-buyers-guide-for-data-aggregation/ (comparing the six top financial data aggregators).

138 Natalie Williams (Chase), Written Statement, *Symposium on Consumer Access to Financial Records* (Feb. 26, 2020), https://www.consumerfinance.gov/about-us/events/archive-past-events/cfpb-symposium-consumer-access-financial-records/.

139 *See, e.g.*, Fin. Data Exch., https://financialdataexchange.org/ (a non-profit corporation who members include banks, data aggregators, and third-party providers and who is developing standard APIs); Clearing House, https://www.theclearinghouse.org/ (a banking association and payments company owned by large commercial banks and which has published a Model Data Access Agreement).

ACCESS TO CONSUMER DATA

The precise methods by which data aggregators access consumer data can be technically complex and are evolving. In general, however, data aggregators use two methods: (1) credential-based access, which employs a process known as "screen-scraping," and (2) APIs. Each involves a consumer providing a data aggregator with permission to access one or more of the consumer's accounts or account data.[140]

Credential-based access involves consumers providing a data aggregator with their online account credentials, namely their user name and password as well as other forms of identity authentication.[141] The data aggregator then uses the consumer's security credentials to access the consumer's online account and to copy or "scrape" this data periodically, often daily. More specifically, the Financial Industry Regulatory Authority (FINRA) has defined screen-scraping as the practice of "using an automated process involving a code or a 'robot' that goes out to the third-party websites, registers using [the consumer's] security credentials, and collects applicable account information."[142]

An API is a structured data feed that connects the account holder, such as the consumer's bank, to the data aggregator.[143] Because an API requires an agreement between the account holder and the data aggregator, parties to an API have the opportunity to agree on terms regarding the scope of data that the account holder will provide to the data aggregator, how often the account holder will provide or update that information, limits on the data aggregator's use or resale of data, and other terms, such as the parties' respective liabilities to each other and the consumer.

APIs do not require consumers to provide their security credentials to the data aggregator; instead, the consumer can authenticate the aggregator with the financial institution, and the institution will provide an access token to the aggregator. As a result, an API may limit a data aggregator's access to certain account information or account services, such as making electronic fund transfers.

AI / Machine Learning

[140] CFPB Data Sharing RFI, *supra* note 132, 83808-09.

[141] CFPB Data Sharing RFI, *supra* note 132, 83808-09.

[142] Fin. Indus. Regulatory Auth., *Know Before You Share: Be Mindful of Data Aggregation Risks*, Investor Alert (Mar. 29, 2018), https://www.finra.org/investors/alerts/be-mindful-data-aggregation-risks.

[143] CFPB Data Sharing RFI, *supra* note 132, 83808-09.

The use of AI, to develop or provide consumer financial services has increased significantly in recent years. "The concept of AI can vary meaningfully, but generally is associated with efforts to enable machines or computers to imitate aspects of human cognitive intelligence, such as vision, hearing, thinking, and decision making."[144] AI has been used in numerous innovations throughout the economy, from internet search engines to facial-recognition software. Within consumer financial services, AI has been used to develop, among other things, improved credit scoring models and fraud prevention tools.

Machine learning is a subset of AI that involves software learning or becoming "smarter" by analyzing data, without the need for additional human intervention. An internet search engine might learn which search results are the "correct" ones by analyzing the links that users click on; it could then make changes to its algorithms so that those links would appear first among future search results. Similarly, machine learning has the potential to help software more effectively identify money laundering and potentially predict fraud or payment default.

The Treasury Department identified three primary technological changes that undergird machine learning's rapid advancement in recent years.[145] First, computing capabilities continue to improve significantly, thereby enabling software to analyze data more quickly. Second, as discussed above, digital data has expanded greatly. Forecasts predicted that 40 times more digital data will be produced in 2020 than in 2009, and more than a billion people have gained access to the internet in the span of approximately a decade—each creating digital data.[146] Third, mobile devices and other internet-connected devices are new sources of data, collecting information on consumers throughout the day. Cell phones, watches, fitness trackers, automobiles, "smart" household appliances, and many other products collect data while consumers engage in a variety of activities, in many cases unbeknownst to the consumer. And once all these data are created, data aggregators play a key role in gathering and sorting them.

Financial services companies use AI and machine learning in numerous ways. For example, and as discussed in more detail below, many creditors are using AI-based credit scoring models to underwrite loans. These models can analyze hundreds or thousands of data points about consumers, including information not traditionally thought of as financial data (*e.g.*, educational background), and find correlations between the inputted data and predicted

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[144] Treasury FinTech Report, *supra* note 124, at 53.

[145] Treasury FinTech Report, *supra* note 124, at 53 (citing Ananad Rao, *A Strategist's Guide to Artificial Intelligence*, STRATEGY + BUSINESS (Summer 2017), https://www.strategy-business.com/article/A-Strategists-Guide-to-Artificial-Intelligence).

[146] A.T. Kearney, *Big Data and the Creative Destruction of Today's Business Models,* at 2 (2013), https://www.co.kearney.com/analytics/article?/a/big-data-and-the-creative-destruction-of-today-s-business-models.

creditworthiness. And they can do so at great savings to the firm: FICO found that using machine learning resulted in a 95 percent reduction in hours to build new credit models.[147] As another example, many companies use AI-based customer-services agents, sometimes known as "chat-bots," who interact with consumers through online or mobile messaging functions. In addition, AI can help to enhance data security or identify fraud or money laundering.

9.4.2 FinTech Products and Services

The technological advances discussed above have enabled financial firms to develop a broad array of innovative products and services that touch on all aspects of consumer finance. A catalogue of all such financial innovations would be voluminous (and likely outdated by the time it was finished), so this section highlights developments in three areas at the core of consumers' financial experiences: how consumers make payments, obtain credit, and manage their finances. In each area, FinTech-based innovation has shown the promise of promoting financial inclusion, though it has also raised consumer protection concerns that existing laws may not address sufficiently.

Payments

GLOBAL DEVELOPMENTS

In many areas of the world, making payments through a mobile device has become "one of the primary ways to accelerate financial inclusion."[148] In those places, mobile money, peer-to-peer (P2P) transfers, digital payments, and remittances can be faster, cheaper, and more widely available to many consumers than are traditional payment methods. By the end of 2017, more than 276 mobile-money services operated across 90 counties, with 191 million active users transferring approximately $1 billion per day. Developing economies in particular have shown rapid rates of adopting mobile money. For example, over two-thirds of adult consumers in the combined populations of Kenya, Rwanda, Tanzania, and Uganda actively use mobile money.[149]

M-Pesa, a Kenyan company, demonstrates mobile money's potential for expanding financial inclusion. At least 84 percent of Kenyan adults living on less than $2 per day—more than 21

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147 Fair Isaac Corp., *Machine Learning and FICO Scores*, at 6 (2018), https://www.fico.com/en/latest-thinking/white-paper/machine-learning-and-fico-scores ("FICO's research team found that building a gradient-boosted decision tree scoring model analogous to the FICO Score took only 40 resource-hours [when using machine learning], compared to the roughly 800 resource-hours typically required to build the scorecards that compose a FICO Score model.").

148 UNGSA, *supra* note 42, at 11.

149 *Id.* (citing GSMA, *State of the Industry Report on Mobile Money 2017* (2018), https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2018/05/GSMA_2017_State_of_the_Industry_Report_on_Mobile_Money_Full_Report.pdf).

million people—have access to M-Pesa.[150] One study showed that M-Pesa's P2P transfers cost users less than traditional payment methods, while the cost savings allowed them to send more money.[151] Another study found that M-Pesa increased per capita consumption levels and lifted 2 percent of Kenyan households, or 194,000 households, out of poverty.[152] M-Pesa and other mobile money providers thus offer "significant benefits for the unbanked and underbanked through lower fees, time savings, and reductions in travel costs," and they have the potential to help lift a small percentage of consumers out of poverty.[153]

China is the leader in mobile payments. By 2018, its mobile payment transaction volume exceeded $41 trillion annually, and two providers—WeChat Pay and Alipay—have more than one billion users each. Their growth has been meteoric: less than a decade in operation, they now serve as the primary payment methods for 90 percent of people in China's largest cities.[154] This development is due in part to the failure of card-based terminals to catch on among many Chinese merchants, who either were reluctant to incur the swipe fees associated with cards or lacked the network connectivity required to process card transactions. WeChat Pay and Alipay use quick response (QR) codes, which require only one party to a transaction to be connected to a network. Thus, so long as the consumer's smartphone can get online, merchants and others can engage in transactions related to P2P money transfers, bill payments, mobile top-ups, ride hailing, insurance, and many other types of payments.[155]

Other forms of mobile digital payments such as bill payments, merchant payments, international remittances, and government disbursements have also demonstrated growth over the past few years. Between 2011 and 2016, these transactions grew from 7.8 percent of all mobile money transactions to 18.8 percent. Notwithstanding that digital payments provide significant benefits for the unbanked and underbanked, they also present potential problems

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[150] *Id* (citing Safaricom, *Safaricom PLC HY2019 Results Presentation, 2nd November 2018* (2018), https://www.safaricom.co.ke/images/Downloads/Resources_Downloads/HY2019/HY2019_Results_Presentation.pdf).

[151] *Id.* (citing Morawczynski, O., *Exploring the Usage and Impact of "Transformational" Mobile Financial Services: The Case of M-Pesa in Kenya*, J. OF E. AFR. STUD., 3(3), 509–525 (2009), https://doi.org/10.1080/17531050903273768).

[152] *Id.* (citing Suri & Jack, *The Long-Run Poverty and Gender Impacts of Mobile Money*, SCIENCE, 354(6317) (2016), http://science.sciencemag.org/content/354/6317/1288).

[153] *Id.*

[154] Aaron Klein, *Is China's New Payment System the Future?*, BROOKINGS INST., June 2019, at 8

https://www.brookings.edu/wp-content/uploads/2019/06/ES_20190620_Klein_ChinaPayments.pdf.

[155] *Id.* at 6-7.

involving fraud by mobile money agents and data security breaches, as customers provide personal information as part of signing up and using the services.

U.S. PAYMENTS MARKET

The U.S. mobile payment market has grown comparatively slowly—it is a small fraction of the size of the Chinese market. According to the Treasury Department, this is in part due to certain barriers to entry and innovation, such as fragmented regulation of payments and the complexity of existing payments systems.[156] Most innovation in U.S. payment systems has been in consumer-facing areas, while the back-end clearing processes and times have remained largely the same. "The user experience, products, and innovative solutions that have been introduced in recent years with the advent of mobile technology, in essence, layer on top of the existing core payment systems."[157] Another impediment is that credit and debit cards work well for wealthy American consumers, who reap rewards benefits while avoiding account fees by paying their account each month, which reduces consumer demand for alternative payment services.[158]

Nonetheless, there have been areas of significant innovation in the mobile payments market. In 2017, a group of seven large U.S. banks established Zelle, a digital payments network.[159] Zelle enables consumers to make a P2P transfer to another registered user through a mobile device or the website of a participating banking institution. It was built on existing debit card infrastructure and allows transfers to clear and post almost instantly. Non-banks such as PayPal and Venmo have also developed significant P2P services. They are typically state-licensed money transmitters and allow consumers to transfer funds to other register users. Consumers can hold funds in their accounts or add or withdraw funds from external sources such as a bank account or credit card.[160]

Lending

UNDERWRITING

FinTech has fostered innovations in both the underwriting of loans and the mechanism by which consumers obtain them. With respect to underwriting, many firms employ machine learning-based analytical tools and credit scoring models. As discussed above, these tools are

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[156] Treasury FinTech Report, *supra* note 124, at 159.

[157] *Id.*

[158] Aaron Klein (2019), *supra* note 154, at 19.

[159] Bank of America, BB&T, Capital One, JPMorgan Chase, PNC Bank, U.S. Bank, and Wells Fargo Bank own Early Warning Services, LLC, which in turn owns Zelle. *See* Early Warning Services, LLC, https://www.earlywarning.com/; Zelle, https://www.zellepay.com/.

[160] Treasury FinTech Report, *supra* note 124, at 148.

capable of processing vast amounts of data and improving their credit-risk predictions over time. Many firms also make use of alternative data, or any information not currently commonly reported on a standard credit report, to assess consumers' credit worthiness. This is particularly important when a consumer is among the tens of millions of "credit invisibles" who have thin or no files at the nationwide consumer reporting agencies and thus may not obtain credit without an alternative scoring method.[161]

There are two main types of alternative data that are used in consumer credit. The first, financial alternative data, are data that are directly related to a consumer's financial history but are not typically recorded on a consumer's credit report. The second type of alternative data, non-financial alternative data, are data typically related to a customer's behavioral habits that may be correlated with their probability of repayment.

Bank transaction data, sometimes called "cash-flow data," is a commonly used alternative data source, as it can include real-time data about deposits, payments, and overdrafts. Other relatively common types of alternative data include:

- On time utility payments, such as electric, water, or cell phone bills. Some consumers may prioritize these payments over other obligations, making them valuable to understanding a consumer's financial situation. These are financial alternative data.
- Rental payments. Services such as Experian's RentBureau obtain rental payment history either directly from certain landlords and property management companies or after obtaining the consumer's permission to contact the landlord to obtain the payment history. These are financial alternative data.
- Information from specialty bureaus regarding payday loans, rent-to-own agreements, and short-term installment loans. For prime borrowers, obtaining such a loan could

[161] Bureau of Consumer Fin. Protect., *Data Point: Credit Invisibles,* at 6 (2015), https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf. *See also* Chris Brummer & Yesha Yadav, *Fintech and the Regulatory Trilemma,* 107 Geo. L.J. 235, 268 (2019). ("With more data to offer, borrowers that may once have been shunned from credit markets might now see themselves more fully included within the financial system. Simply relying on FICO scores or established credit histories might exclude communities that have historically lacked access to credit or financial services. A broader and more diverse set of data—including a user's social contacts or shopping habits—may allow opportunities to foster greater inclusion in credit markets. [...] But there are also reasons for caution. For one, finding statistical connections and meaning within large datasets is far from straightforward, and regulators and market participants can face high analytical costs in cleaning, collating, interpreting, and handling vast stores of data... Alternatively, digital datsets can lead to disparate and even unfair outcomes for would-be clients and customers. Historically disadvantaged minority communities, for example, could fare worse, not better, under some analytical systems dependent on longstanding records of using banking and insurance services.151 Where the availability of data is limited due to the de jure or de facto exclusion of such subgroups from credit systems, some lending algorithms may infer that higher interest rates and tighter credit conditions are warranted, and impose such terms accordingly. Such communities may also find themselves especially vulnerable to invasions of privacy and the accessing of sensitive data.").).

signal final distress. For a non-prime borrower, a history of repaying these loans could help demonstrate credit worthiness. These are financial alternative data.

- Social media accounts. Accounts that are newly created, have few connections, or contain information that differs from information on the consumer loan application can suggest fraudulent activity. These are non-financial alternative data.
- Educational background. A college or other degree could indicate greater job security and a higher income.[162] These are non-financial alternative data.

A 2018 industry survey of 22 large firms found that bank account transaction data and utility and bill payment were the most commonly used type of alternative data.

The use of alternative data in underwriting raises concerns that warrant consideration. Some alternative data sources may be more prone to errors than data from traditional sources and could harm consumers with thin or no credit files. These accuracy concerns are exacerbated when the source of the information does not typically furnish information and thus may not have robust FCRA-procedures in place. In addition, underwriting models that use alternative data and machine learning could lead to discrimination on prohibited bases or, if insufficiently tested, make credit decisions based on spurious correlations from the data. The complexity of these models also makes it extremely difficult for consumers, creditors and regulators to understand how the inputted data relates to credit decisions.[163] And apart from the accuracy of the data or underwriting, consumers may also have concerns about the scope of data that is shared with third parties. Section V explores these issues in more detail.

Early findings suggest that use of machine learning and alternative data, in particular bank account transaction data, can promote financial inclusion by giving lenders a more accurate view of a consumer's creditworthiness. FinRegLab, a non-profit organization, studied data from six non-bank lenders that used cash-flow data and found that the "predictiveness of the cash-flow scores and attributes was generally at least as strong as the traditional credit scores and credit bureau attributes studied." It further found that "participants appear to be serving substantial numbers of borrowers who may have historically faced constraints on their ability to

[162] Experian & Aite, *Alternative Data Across the Loan Life Cycle: How FinTech and Other Lenders Use It and Why* (2018), https://www.experian.com/assets/consumer-information/reports/Experian_Aite_AltDataReport_Final_120418.pdf?elqTrackId=7714eff9f5204e7ca8517e8966438157&elqaid=3910&elqat=2.

[163] *See, e.g.,* Steve Dickerson, *et al.*, *Machine Learning: Considerations for Expanding Access to Credit Fairly & Transparently*, at § 4.2.6 (2020), http://info.h2o.ai/rs/644-PKX-778/images/Machine%20Learning%20-%20Considerations%20for%20Fairly%20and%20Transparently%20Expanding%20Access%20to%20Credit.pdf.

access credit." At the same time, FinRegLab did not observe fair lending concerns.[164] Evidence from LendingClub, a large FinTech lender, shows that increasing reliance on alternative data improves credit ratings of borrowers on the margins faster than relying solely on FICO scores.[165] These borrowers tend to be disproportionately protected classes.[166] And, as noted above, the Bureau issued its first no-action letter to a company that used traditional credit bureau data and alternative data and machine learning in its underwriting and pricing model.[167] As a condition to receiving the no-action letter, the company agreed to a model risk management and compliance plan which required it to analyze and appropriately address risks to consumers, as well as assess the real-world impact of alternative data and machine learning. Pursuant to the no-action letter, the company provided the Bureau with information comparing outcomes from its underwriting and pricing model (tested model) against outcomes from a hypothetical model that uses traditional application and credit file variables and does not employ machine learning (traditional model). The company independently validated the traditional model through fair lending testing to ensure that it did not violate antidiscrimination laws and shared access to credit and fair lending testing data with the Bureau. The results of the testing data were performed by the company and were not separately replicated by the Bureau. The results provided from the access-to-credit comparisons show that the tested model approves 27 percent more applicants than the traditional model and yields 16 percent lower average APRs for approved loans. The reported expansions of credit access reflected in the results occurres across all tested race, ethnicity, and sex segments.

ALTERNATIVE LENDING / P2P LENDING

Non-bank FinTech lenders, also referred to as marketplace lenders, have grown rapidly in recent years. From 2013 to 2018, the share of unsecured consumer loans involving non-bank FinTech lenders rose from 5 percent to 38 percent.[168] Unlike traditional lenders, marketplace lenders operate largely or entirely online, taking credit applications through their websites or mobile

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164 FinRegLab, *Fact Sheet: Cash-Flow Data in Credit Underwriting*, available at https://finreglab.org/fact-sheet-cash-flow-data-in-credit-underwriting/

165 Julapa Jagtiani & Catharine Lemieux, The Roles of Alternative Data & Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform, FEDERAL RESERVE BANK OF PHILADELPHIA Working Paper 18-15 (2018), http://leeds-faculty.colorado.edu/bhagat/FintechLending.pdf.

166 Bureau of Consumer Fin. Protect., *Data Point: Credit Invisibles*, at 17-18 (2015), https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

167 Bureau of Consumer Fin. Protect., *An Update on Credit Access and the Bureau's First No-Action Letter* (Aug. 6, 2019), https://www.consumerfinance.gov/about-us/blog/update-credit-access-and-no-action-letter/.

168 TransUnion, *FinTechs Continue to Drive Personal Loan Growth*, press release, Feb. 21, 2019, https://www.globenewswire.com/news-release/2019/02/21/1739107/0/en/FinTechs-Continue-to-Drive-Personal-Loan-Growth.html.

apps rather than through in-person transactions. They also often use vast amounts of consumer data, including alternative data, in marketing and underwriting loans.

Marketplace lenders employ two primary models: (i) a partnership with a bank, in which the bank originates the loan, but the marketplace lender sources, services, and funds it; and (ii) direct lending, in which case the marketplace lender has acquired the necessary state licenses to do business.[169] A bank partnership has the advantage of allowing the marketplace lender to piggyback on the bank's ability to extend loans to the maximum rate permitted in the bank's home state, even if that rate is higher than permissible in the consumer's home state.

Consumers at the margins—those with poor or no credit history or who have been discriminated against—may particularly benefit from marketplace lending. Because banks and other traditional lenders meet the credit demands of wealthier consumers, marketplace lenders have an incentive to seek out consumers who may have had difficulty obtaining credit in the past. Consumers at the margins are also the most vulnerable to predatory lending, raising concerns that marketplace lending often involves loans with higher interest rates or borrowing costs when compared to bank loans. In addition, there are concerns that such lending can result in over-indebtedness or give rise to fraud.[170]

9.4.3 Digital Savings and Financial Management

FinTech has enabled firms to offer an array of digital savings, investment, and financial planning products to consumers at low cost and with customized benefits. These can range from relatively simple savings tools, such as programs that automatically transfer funds at regular intervals to a savings account, a dedicated savings account linked to a mobile money application, or the ability to store cash in a mobile money account.[171] These digital options can be less costly and facilitate faster payments than traditional bank accounts. They also can help customers develop savings plans and allow them to receive automatic "nudges," or reminders, that encourage saving on a regular basis—services that could be significantly more costly if a bank's employee provided them.[172] Existing applications also can automatically move a consumer's money between accounts to avoid overdraft fees.

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[169] Treasury FinTech Report, *supra* note 124, at 85.

[170] UNGSA, *supra* note 42, at 12.

[171] *Id.* at 13.

[172] *Id.*

Other firms use data analytics, machine learning, and other computing advances to offer more sophisticated financial management tools. Data aggregation-based services can enable a consumer to go on financial "autopilot" by simplifying complex decisions and providing new ways of looking at a consumer's overall financial picture.[173] Services include product comparisons, investment or debt management, and budgeting. For example, a small portion of credit card users miss deadlines for earning promotional rates, and a small portion of bank-account holders pay the majority of overdraft fees. AI-based applications that use aggregated consumer data could help consumers predict whether they are the ones likely to pay the fees. In other cases, AI-based applications provide financial advice by comparing a consumer's income and expenses to those of other consumers and making recommended budget changes. More generally, AI-based applications can help predict how a consumer is likely to fare with a particular financial product or service and recommend to the consumer whether to purchase that product or service.

FinTech companies are able to provide financial management at a lower cost because, among other things, they generally require few live employees, enabling consumers to obtain services traditionally reserved for the wealthier. Digital financial planning can also benefit younger consumers, such as those who are entering the work force, when their savings may be small or non-existent.[174] By establishing a pattern of saving and investing during this stage, consumers can build both positive savings habits and long-term wealth.

9.5 Regulatory Framework

Responsible innovation in the consumer financial services market, including related to FinTech, has demonstrated that it has the potential to benefit consumers immensely by promoting competition and financial inclusion. By offering products and services that cost less, execute faster, and are accessible from mobile and other digital platforms, FinTech innovators can reach consumers on the margins of the financial services markets. Similarly, data aggregation services can enable firms to consider larger datasets that provide a more complete picture of a consumer's finances and expand the notion of a creditworthy consumer. Digital offerings also make product and price comparisons easier for consumers, encourage new entrants to key

173 Lael Brainard, *Where Do Consumers Fit in the Fintech Stack?*, at 1 (Remarks at *FinTech Risks and Opportunities: An Interdisciplinary Approach*) (Ann Arbor, Michigan, Nov. 16, 2017), https://www.federalreserve.gov/newsevents/speech/brainard20171116a.htm.

174 Treasury FinTech Report, *supra* note 124, at 161.

markets, and enable existing firms to expand their offerings, thereby increasing competition and consumer benefit.

At the same time, FinTech innovations carry significant risks, which are exacerbated by a regulatory regime with uncertain protection for consumers or obligations for service providers. There is significant uncertainty in at least three key areas: (1) the array of federal and state laws governing non-bank FinTech firms offering payments, lending, and other services; (2) rules regarding the control and use of consumer data, particularly with respect to data aggregators and alternative data; and (3) the use of alternative data and machine learning in underwriting. The next section explores policymakers' challenges and options in these areas.

9.5.1 Regulation of Non-Bank FinTech Companies

Current Framework and Concerns

For many non-bank FinTech companies—including those that offer payments, remittances, and lending services—state laws provide the primary regulatory framework.[175] With state law typically comes registration or licensing requirements. Many non-bank FinTech companies must therefore acquire a separate license for each state in which they operate, and a nationwide footprint means acquiring a license in every state or territory.[176]

The Treasury Department's 2017 FinTech Report identified a number of potential advantages of the state regulatory model. Chief among them, states serve as "laborator[ies] of innovation," able to test different approaches to new technologies, practices, and types of firms. The state model also has allowed firms to develop within a state before expanding operations. And state regulators may be able to respond best to the needs of their constituents."[177]

The state model also presents a variety of drawbacks. Firms incur significant expense maintaining state licenses, ensuring compliance with each state's laws, and monitoring legal

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[175] Id. at 63-64.

[176] Some FinTech companies engaged in marketplace lending (discussed above) have avoided certain state-by-state requirements by piggybacking on a bank's ability to export home-state interest rates. The Second Circuit's 2015 decision, *Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015),* threatened this arrangement by holding that a non-bank taking assignment of a loan originated by a national bank is not entitled to preemption from state usury laws. Since then, the OCC and FDIC have engaged in rulemakings to effectively overrule Madden as well as to clarify which entity is the "true lender" for assigned loans. As a result, non-bank FinTech companies' ability to avoid being subject to a wide variety of state laws is uncertain and in any event is limited to lending.

[177] Treasury FinTech Report, *supra* note 124, at 66.

developments in each state.[178] These costs, many of which are relatively fixed, can be most burdensome for small companies or potential new market participants.[179] Differences in state laws can also require firms to vary material attributes of their products or services depending on the applicable law.[180] In some cases, such as with rate ceilings, state law may effectively prevent firms from offering products or services in certain locations. The inability of FinTech lenders to export their home-state interest rate can also make it difficult for them to compete with banks when offering similar products.

9.5.2 Lessons from the National Commission on Consumer Finance Report

The National Commission on Consumer Finance's (NCCF) 1972 report addressed analogous issues regarding the regulation of consumer finance companies.[181] The NCCF noted that several types of financial institutions offering consumer credit could choose to operate under either a federal or state charter, and it identified a number of potential benefits and risks of extending dual chartering to finance companies. General benefits included overcoming restrictions on market entry and innovation. More specifically, the NCCF observed that incumbents, typically banks, often made unfounded economic arguments when lobbying states to impose restrictions on potential competitors. In turn, states sometimes rely on "specious" reasons to limit new market entrants, such as when certain states imposed "convenience and advantage" tests for licensing financing companies.[182] Because finance companies do not accept deposits, the NCCF could not perceive any threat to consumers or market stability from greater competition in consumer lending.

Next, the NCCF stated that "[o]ne of the most effective ways competition serves consumer interests is in the development of new products and services," and it identified at least four innovations that federal chartering could advance innovation.[183] First, federal chartering could lift the "oppressive restraint[]" of low ceilings on loan sizes, which increased costs to consumers

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178 Treasury FinTech Report, *supra* note 124, at 65 (stating that, among other things, "some firms report that all-in licensing costs range from $1 million to $30 million"); Brian Knight, *Federalism and Federalization on the Fintech Frontier*, 20 Vanderbilt J. OF ENT. & TECH. L. 129, 186 (2017).

179 Knight (2013), *supra* note 178, at 112-113.

180 Treasury FinTech Report, *supra* note 124, at 65.

181 Report of The National Commission on Consumer Finance (NCCF), Consumer Credit in the United States, Chapter 9 (Dec. 1972).

182 NCCF (1972), *supra* note 181, at 163.

183 NCCF (1972), *supra* note 181, at 163.

by requiring them to take out multiple smaller loans instead of one larger loan.[184] Second, evidence suggested that federal chartering could permit consumers to renew loans more frequently. Third, it could also allow finance companies to extend loans at interest rates above what the consumer's home state permitted, thus encouraging lending to higher-risk consumers. Finally, state laws restricted the scope of credit-related services that finance companies could offer, and the NCCF postulated that removing such limitations could allow finance companies to provide "one-stop shopping" for consumers seeking to invest funds or obtain credit, perhaps running the gamut from revolving credit to mortgage loans.[185]

The NCCF also identified two potential arguments against federal chartering of finance companies. First, it noted that consumer credit was primarily a local function, with finance companies typically making loans to consumers within a small geographic region, sometimes just a few city blocks. Combined with their inability to accept deposits, finance companies' operations thus did not implicate the broader public interest. Second, the NCCF warned that credit markets were already subject to a "wide and rather haphazard variety of laws within most of the states" and, unless Congress were willing to preempt all states' laws, creating a new class of federally chartered finance companies could add to the complexity and regulatory segmentation of the consumer credit market.[186]

The NCCF concluded its analysis with a multi-pronged recommendation. As an initial step, the NCCF recommended that states remove anticompetitive restrictions on competition and innovation and that Congressionally directed research be conducted into the levels of competition and innovation in various states and local communities. In the event that these steps were not taken within four years of the NCCF's Report, the NCCF recommended that Congress empower a new Bureau of Consumer Credit to issue national charters and supervise finance companies. Under this proposal, federal charters would allow finance companies to supersede state laws restricting market entry, rate ceilings, and the forms and terms of consumer credit (*e.g.*, loan size or term). The BCC would be charged with establishing reasonable rate ceilings for federally chartered finance companies, while state law would continue to govern debtors' rights and creditors' remedies. As to supervision, the NCCF recognized the potential value of various different arrangements, from having federal examiners

[184] NCCF (1972), *supra* note 181, at 163.

[185] NCCF (1972), *supra* note 181, at 164.

[186] NCCF (1972), *supra* note 181, at 165.

supervise for compliance with both state and federal laws, to dividing responsibilities between federal and state examiners.[187]

9.5.3 Potential Regulatory Frameworks

Much of the NCCF's analysis is applicable to the question whether a national approach would be preferable to a state-by-state approach for regulating non-bank FinTech companies. In particular, non-bank FinTech lenders remain subject to state laws imposing rate ceilings and have difficulty providing one-stop shopping to consumers. Regulation of the consumer credit market remains segmented and adding a new federal scheme could increase complexity. But one key observation is inapplicable to non-bank FinTech company: Their lending practices are not primarily a local function. They operate digitally, across state lines, through websites and mobile apps, often with few or no physical retail locations. Consequently, non-bank FinTech lenders are capable of providing services to consumers spread throughout the U.S.

Given the anticompetitive features of the current state-by-state approach and the absence of any natural geographic limitations on FinTech companies, it appears that a national approach would greatly benefit consumers and competition.[188] There are numerous specific frameworks one could consider,[189] but two general approaches stand out: (i) a federal charter and (ii) permitting non-bank FinTech companies to export their home-state laws even without a federal charter.

Under the federal-charter approach, a federal agency could issue national charters to non-bank FinTech companies that satisfied certain criteria. The OCC took a significant step in this direction in July 2018, announcing that it would grant national bank charters to certain FinTech lenders, even if they do not take deposits.[190] The OCC explained that a FinTech company with a national bank charter would be subject to the same safety-and-soundness standards as all federally chartered banks. It also stated its expectation that such FinTech companies would

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[187] NCCF (1972), *supra* note 181, at 165-67.

[188] *See, e.g.*, Knight, 20 Vanderbilt J. OF ENT. & TECH. L. at 185 ("Commentators who likely disagree significantly on what the substance of the law should be nevertheless recognize the value of efficiency provided by consistent national rules. Whether efficiency is best served by federalism or federalization is a case-by-case question. For example, Professor Barry Weingast describes 'market-preserving federalism,' in which a federalist structure encourages competition among governments in the regulation of markets and thus discourages rent-seeking and contributes to greater prosperity. If a market met those criteria, federalization would be unnecessary, if not harmful.").

[189] See generally License to Bank: Examining the Legal Framework Governing Who Can Lend & Process Payments in the Fintech Age: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech. (Sept. 29, 2020), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=406871.

[190] Office of the Comptroller of the Currency, *Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters* (July 31, 2018), https://www.occ.gov/news-issuances/news-releases/2018/pub-other-occ-policy-statement-fintech.pdf.

demonstrate a commitment to financial inclusion.[191] A chartered FinTech company would not be subject to the varying state laws, including usury laws, but rather could export its home-state interest rate and preempt other state requirements.[192] Since then, the OCC also announced plans for a payment charter that could allow FinTech companies offering payment processing services (*e.g.*, remittances), but which do not accept deposits or make loans, to operate with the equivalent of a national money-transmitter license and potentially gain access to the Federal Reserve's payments system.[193]

The OCC has encountered legal obstacles,[194] but, even so, Congress could ultimately choose to give the OCC, the Bureau, or another agency clear authority to issue federal charters to non-bank FinTech companies. This approach's benefits would include reducing the costs that these companies incur to maintain licenses in various states as well as the costs to comply with the laws of different states. It would also provide regulatory clarity for non-bank FinTech companies and consumers as well as potentially level the playing field by making banks and non-banks subject to similar laws. And, consumers could choose from among the same services and service providers, regardless of where they live, thereby furthering competition.

There are some potential drawbacks of a federal-charter approach. Most notably, a single federal model would largely replace states' ability to experiment with different approaches and laws. Extending the existing regulatory regime for banks to non-bank FinTech companies, as the OCC attempted to do, also may be an ill-suited fit. Banks already bear a significant regulatory burden that can impede innovation, and subjecting non-bank FinTech companies to the same burdens could likewise impede the innovation that charters would be intended to foster.[195] To that end, some non-bank FinTech companies have purposely organized themselves in ways that avoid the regulatory burden that banks face, potentially making a federal charter unattractive for them.[196] Some industry members have also questioned whether the OCC's expertise in some areas, such

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191 Id.

192 Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).

193 *See* Judith E. Rinearson & Mehreen Ahmed, *It's Ba-ack! OCC Planning A New Fintech Charter: "Payments Charter 1.0,"* 10 NAT'L L. REV. 188, July 6, 2020.

https://www.natlawreview.com/article/it-s-ba-ack-occ-planning-new-fintech-charter-payments-charter-10.

194 *Lacewell v. Office of Comptroller of Currency,* No. 18 CIV. 8377 (VM), 2019 WL 6334895 (S.D.N.Y. Oct. 21, 2019) (holding that the OCC exceeded its authority by purporting to grant charters to companies that do not accept deposits).

195 Treasury FinTech Report, *supra* note 124, at 65-66 ("Banks face their own regulatory regimes, which are quite extensive and can impede innovation.").

196 Howell E. Jackson, *The Nature of the Fintech Firm,* 61 WASH. UNIV. J.L. & POL'Y 9, 13-14 (2020).

as payments, translates to the lending context.[197] The OCC should be sensitive to the fact that many FinTech firms do not hold federally insured deposits, which suggests a less-stringent capital requirement may be appropriate—if any requirement is needed at all.

Under the second approach, Congress would enact legislation that prohibits states from applying certain of their laws to non-bank FinTech companies chartered in other states. Only the FinTech's home-state laws would apply. Thus, a non-bank FinTech company based in Nebraska could charge the same maximum interest rate for all loans it originates, regardless of whether a consumer resides in Nebraska, Minnesota, or elsewhere.

Chapter 10 discusses in detail the profound impact that the *Marquette* decision had on consumers and competition, much of which could be replicated in the non-bank FinTech markets. By removing price controls that prevent riskier applicants from obtaining loans, this approach could enable more accurate risk-based pricing of credit offers and lending that would disproportionately benefit consumers who are excluded by rationing. Reducing barriers to entry could increase competition in states where consumers are currently underserved, promoting a greater variety of options for consumers. This approach could also spur competition between states to develop appropriate regulatory regimes and attract FinTech companies, preserving the benefits of states serving as laboratories of experimentation.

The second approach also has drawbacks. It would continue to subject non-bank FinTech companies to different regulatory regimes than federally chartered banks, even when they are engaged in the same activities. There is also the potential for a "race to the bottom," in which some states develop regulations that attract FinTech companies but that do not sufficiently protect consumers. Even if such a race occurs, and its existence has been questioned in other contexts,[198] the Bureau has adequate authority to adopt regulations that would prevent significant consumer harm. Policymakers will need to weigh these potential benefits and risks in determining the best path forward.

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[197] License to Bank: Examining the Legal Framework Governing Who Can Lend & Process Payments in the Fintech Age: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech., at 6-7 (Sept. 29, 2020) (testimony of Evert K. Sands, Lendistry), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-sandse-20200929.pdf.

[198] See Jonathan H. Adler, Adler, Jonathan H., Let Fifty Flowers Bloom: Transforming the States into Laboratories of Environmental Policy, SSRN (January 2002).

9.5.4 Regulating the Sharing and Use of Consumer Data

Many of the recent innovations described above rely on third parties, often data aggregators, accessing a consumer's financial data and either using it to provide services to the consumer or transferring it to another party who will provide such services. Currently, there is significant uncertainty about the circumstances in which a financial institution must or may share data with a third party. Also uncertain is the degree to which existing laws apply to third parties and any resulting limits on their ability to use or transfer consumer data.

The Bureau has initiated a rulemaking that will consider these issues,[199] so it is not necessary for the Taskforce to address them all in detail. It is nonetheless worthwhile to outline a few of the relevant laws and considerations about which the Bureau and the public may wish to be mindful.

Current Regulatory Ambiguities and Consumer-Protection Concerns

SECTION 1033 OF THE DODD-FRANK ACT

Section 1033 of the Dodd-Frank Act is at the center of a consumer's ability to share account data with a third party.[200] It requires a covered person to, upon the consumer's request, provide the consumer with information concerning the product or service that the consumer obtained from the covered person, subject to certain exceptions. Such information "includ[es] information relating to any transaction, series of transactions, or to the account including costs, charges and usage data." The covered person must make the information available in an electronic form usable by consumers.

The Bureau has determined that rulemaking to implement Section 1033 is warranted. A key issue is whether a third party acting with the consumer's authorization is the "consumer" under Section 1033. And, if it is, whether and in what circumstances the account holder can limit the third party's data access due to, among other things, concerns about fraud or other data misuse.[201]

CONSUMER CONSENT, PRIVACY, AND DATA SECURITY

Although data aggregators obtain a consumer's consent before accessing or using data about the consumer, widespread concern exists that (1) consumers do not provide *meaningful* consent, and (2) data aggregators obtain more data, and retain it longer, than necessary to provide their

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[199] Bureau of Consumer Fin. Protect., *Consumer Access to Financial Records,* 85 FED. REG. 71003 (Nov. 6, 2020).

[200] 15 U.S.C. § 5533.

[201] *E.g.,* 85 FED. REG. 71003, 71010.

product or service. For example, The Clearing House's 2019 consumer survey found that 80 percent of FinTech app users were not fully aware that the apps or third parties may store their bank account username and password and that, once aware of this fact, most surveyed consumers were uncomfortable with the level of access they had shared. The survey further found that less than a quarter of FinTech app users knew that financial apps often continue to have ongoing access to their data until the consumer affirmatively revokes authorization.[202]

Stakeholders have also highlighted concerns that data aggregators' user agreements are often unclear or silent about how consumers can opt of data collection.[203] Stakeholders note that agreements state that the company will not store the consumer's account credentials or other information, but that they fail to disclose that the FinTech company will use a third-party data aggregator and that the aggregator will retain the consumer's credentials and other data. In addition, user agreements also may omit terms regarding the duration of an aggregator's access to data, which can result in perpetual access unless the consumer affirmatively withdraws consent.[204]

Other regulators, including the Financial Crimes Enforcement Network and FINRA, have noted that some criminals are using FinTechs to initiate fraudulent transactions.[205]

APPLICATION OF THE GLBA AND FCRA TO THE USE, SHARING, AND ACCURACY OF CONSUMER DATA

Stakeholders advised that federal regulators have yet to examine data aggregators for compliance with the Gramm-Leach-Bliley Act (GLBA) or Privacy and Safeguards Rules, and that there may be some uncertainty about whether a data aggregator is a "financial institution"

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[202] Clearing House, *Consumer Survey: Financial Apps & Data Privacy,* at 3 (Nov. 2019), https://www.theclearinghouse.org/-/media/New/TCH/Documents/Data-Privacy/2019-TCH-ConsumerSurveyReport.pdf.

[203] Lael Brainard, *Where Do Consumers Fit in the Fintech Stack?,* at 14-15 (Remarks at *FinTech Risks and Opportunities: An Interdisciplinary Approach*) (Ann Arbor, Michigan, Nov. 16, 2017), https://www.federalreserve.gov/newsevents/speech/brainard20171116a.htm. *See also* Marcus Moretti & Michael Naughton, *Why Privacy Policies Are So Inscrutable,* THE ATLANTIC (Sept. 5, 2014), https://www.theatlantic.com/technology/archive/2014/09/why-privacy-policies-are-so-inscrutable/379615/.

[204] Bureau of Consumer Fin. Protect., *Bureau Symposium: Consumer Access to Financial Records—A Summary of the Proceedings* 4-5 (July 2020) https://files.consumerfinance.gov/f/documents/cfpb_bureau-symposium-consumer-access-financial-records_report.pdf.

[205] Prepared Remarks of FinCEN Director Kenneth A. Blanco, delivered at the Federal Identity Forum and Exposition, *Identity: Attack Surface and a Key to Countering Illicit Finance* (Sept. 24, 2019), https://www.fincen.gov/news/speeches/prepared-remarks-fincen-director-kenneth-blanco-delivered-federal-identity-fedid; Fin. Indus. Regulatory Auth., *Know Before You Share: Be Mindful of Data Aggregation Risks,* Investor Alert (Mar. 29, 2018), https://www.finra.org/investors/alerts/be-mindful-data-aggregation-risks.

subject to the statute and Privacy and Safeguards Rules. Similarly, neither the Bureau nor the FTC appear to have taken a position on whether a data aggregator is a consumer reporting agency (CRA) or, if it is, whether a financial institution that provides access to consumer data is a "furnisher" under the FCRA. Based on the FCRA's plain language, it would appear that many data aggregators would be CRAs if they assemble or evaluate consumer credit information and provide it to third parties for the purpose of, among other things, making credit decisions. The furnisher questions raise complex potential legal questions given that financial institutions sometimes provide data through an API and other times have it taken from them through credential-based access.[206] Resolving these legal questions may also have significant impact on the incentives financial institutions have to share data with third parties.

APPLICATION OF LAWS LIMITING A CONSUMER'S LIABILITY

EFTA, as implemented by Regulation E, limits a consumer's liability arising from unauthorized electronic funds transfers.[207] TILA, as implemented by Regulation Z, does the same for unauthorized credit card use.[208] Questions arise as to whether consumers who share their account login credentials with a data aggregator still enjoy these liability limits and, if so, whether the data aggregator or the financial institution (*e.g.*, the consumer's bank) is responsible for making the consumer whole. While APIs may include provisions allocating liability, the Bureau may be pushed to provide a consistent default rule.

APPLICATION OF UDAAP PROHIBITIONS

The Bureau and the FTC have found that entities engaged in deceptive or unfair acts or practices under the Dodd-Frank Act and FTC Act by falsely representing to consumers that the entity employed reasonable and appropriate measures to protect consumer data or otherwise failed to take appropriate steps to secure consumer data.[209] These agencies will need to consider how the UDAAP prohibitions apply to consumer-authorized data access in a way that is consistent with how it resolves the other questions discussed above.

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[206] The dichotomy between APIs and credential-based access is sometimes blurred, as the latter can involve cooperation between data aggregators and financial institutions. As the Bureau observed, through a practice called "whitelisting," a "[data] aggregator identifies its traffic to the bank, which allows the bank to permit the aggregator to access consumer data via credential-based access and screen scraping." Bureau of Consumer Fin. Protect., *Consumer Access to Financial Records*, 85 Fed. Reg. 71003, 71007 n.19 (Nov. 6, 2020).

[207] EFTA section 909(a); 15 U.S.C. § 1693g(a); 12 C.F.R. § 1005.6(b)(2).

[208] TILA section 133; 15 U.S.C. § 1643; 12 C.F.R. § 1026.12(b).

[209] *See, e.g.*, Bureau of Consumer Fin. Protect., File No. 2016-CFPB-0007 (Dwolla, Inc.), http://files.consumerfinance.gov/f/201603_cfpb_consentorder-dwolla-inc.pdf; FTC Matter/File Nos. 1023142–X120032 (Wyndham Worldwide Corp.); 052–3148 (CardSystems Solutions, Inc.); 052–3136 (Superior Mortgage Corp.); 052–3096 (DSW Inc.); 052–3117 (Nations Title Agency, Inc.); 062–3057 (Guidance Software, Inc.); 072–3046 (Life is good, Inc.); 072–3055 (TJX Companies); and 052–3094 (Reed Elsevier, Inc.).

9.5.5 Regulatory Approaches to Open Banking

As it implements Section 1033 of the Dodd-Frank Act and potentially clarifies application of other laws to consumer-authorized data access, the Bureau may wish to consider three observations. First, property law concepts—who "owns" consumer data—are unlikely to be useful in resolving complicated legal and policy questions. Advocates of open banking sometimes urge the Bureau to clarify that consumers (not account-holding institutions) own the account data. If one accepts this proposition, it may follow that consumers have the right to access that data and share it with third parties, and account-holding institutions could not deny access to a consumer-authorized third party. But, as Professor Emma Leong notes, "property law struggles to accommodate data ownership" because fundamentally "the concept of ownership sits uneasily with data."[210] Data ownership might entail the ability to exclude others from using or accessing it, but this is inconsistent with the reality that the account-holding institution necessarily retains and uses the data and can usually furnish it to third parties consistent with applicable law. Moreover, establishing who owns the data does not answer all relevant questions. It leaves open the question of when an account-holding institution should refuse to share data with a third party suspected of fraud. Resolving these policy questions first may help better inform the scope of any consumer right to access data.

Second, in developing an open banking regime, the Bureau will need to make a choice between a "supportive" and a "mandatory" approach. In general, open banking has three characteristics: "[1] customers having greater access to and control over their banking data; [2] financial institutions being required to share customer data with customers; and, [3] with the consent of customers, financial institutions sharing customer data with accredited third party providers. . . , which may include competing providers of financial services."[211]

In a supportive jurisdiction, regulators take steps to facilitate open banking without mandating it.[212] Existing banking laws or general data privacy rules govern a consumer's right over account data. For example, in Singapore (as in the U.S.), account-holding institutions share information with third parties when doing so complies with existing bank secrecy and data protection

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[210] Emma Leong, *Open Banking: The Changing Nature of Regulating Banking Data—A Case Study of Australia and Singapore*, 35.3 Banking & FIN. L. REV. 443, NUS Centre for Banking & Finance Law Working Paper 20/02, at 11 (2020). Further, "[i]nformation may give rise to intellectual property rights but the law has been reluctant to treat information itself as property. When information is created and recorded for example to constitute an electronic database, there is a distinction between the information itself, the physical medium on which it is recorded (such as a disk) and the rights (such as database right and copyright) to which the information gives rise. Whilst the physical medium and intellectual property rights are treated as property, the information itself is not." *Id.*

[211] Leong (2020), *supra* note 210, at 1.

[212] Leong (2020), *supra* note 210, at 3.

regulations.[213] Regulations do not require the institution to use a particular means of sharing data (*e.g.*, APIs), and the third party does not have strictly defined rights or obligations. Rather, a consumer's right to share data is determined largely by contract. Institutions can charge reasonable fees or deny overly burdensome data-sharing requests.

In a mandatory jurisdiction, regulators have enacted laws to compel adoption of open banking practices. Laws define the rights and duties of third parties (*e.g.*, data aggregators) with respect to consumer data.[214] They also mandate the methods by which a third party can access—and the account-holding institution provides—information. They further address the types of data subject to mandatory sharing. Notably, choosing a mandatory open banking approach would seem to necessitate rules defining what constitutes a trusted third party to whom a financial institution must share data. Australia, for example, requires accreditation, and the European Union subjects the third parties to the same privacy and other regulators as the account-holding institution. These regimes have also identified specific categories or types of data subject to mandatory sharing.[215]

Third, the Bureau can use its Office of Innovation to inform and supplement its rulemaking. The Bureau's innovation efforts—including the sandboxes, no-action letter policy, pilot advisory opinion program, and tech sprints—are still in their relative infancy. They have nonetheless shown great promise, and the Bureau would be wise to continue using them so that it can both encourage consumer-protective innovation and learn from its partnerships with market participants.

9.5.6 Regulation of Alternative Data and Machine Learning

As discussed in Section IV.B. above, use of alternative data and machine learning has the potential to promote financial inclusion, when carefully implemented and monitored.

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[213] Id.; Treasury FinTech Report, *supra* note 124, at 34.

[214] Leong (2020), *supra* note 211, at 3. In a comparison of supportive and mandatory banking regimes in Singapore and Australia, respectively, Professor Leong concluded that a mandatory approach is better suited to achieve open banking goals of responsible sharing of accurate information.

[215] Australian regulators have identified four categories of information that may require differing treatment: (1) customer–provided data; (2) transaction data; (3) value–added customer; and (4) aggregated data sets. The European model draws a distinction between regulated account information service providers (AISPs) and payment initiation service providers (PISPs), each being subject to different regulations that acknowledge their respective risk profiles. Alternatively, many stakeholders have suggested that the Bureau limits access to those data that are for the express purpose for which consumer has shared or to certain limited purposes that the law defines. See, e.g., *License to Bank: Examining the Legal Framework Governing Who Can Lend & Process Payments in the Fintech Age: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech.*, at 22-23 (Sept. 29, 2020) (testimony of Raúl Carillo), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-carrillor-20200929.pdf (recommending that Congress limit data usage to specific categories rather than relying on consumer consent and collecting sources).

Consumers at the margin—those who score poorly or not at all under traditional crediting scoring models and who are disproportionately members of protected classes—may stand to gain the most from new underwriting methods. FinTech companies appear to be the most likely lenders. Banks and other lenders meet the credit demands of consumers with strong scores under traditional models (*e.g.*, FICO), giving FinTech companies an incentive to use tools that identify which of the remaining consumers are also creditworthy.[216] FinTech companies' reliance on digital platforms also may make them less apt to discriminate: One analysis found that racial discrimination occurs in both face-to-face and FinTech lending, but that FinTech lenders discriminate 40 percent less on pricing and effectively not at all in underwriting.[217]

Nonetheless, use of alternative data and machine learning methods raises numerous consumer protection and regulatory concerns, especially as it relates to bias and discrimination. Black box machine learning models—particularly when paired with alternative data—raises the specter of difficult-to-detect discrimination.

Accuracy Concerns and the FCRA

The FCRA imposes various requirements to assure the accuracy of information used to make credit decisions. CRAs must follow "reasonable procedures to assure maximum possible accuracy of the information" in consumer reports.[218] Users of consumer reports must provide notice to the consumer when they take adverse action based on information in a consumer report.[219] And consumers have the right to dispute errors in their credit files with either a CRA or the party that furnished the information.[220]

While alternative data that third parties collect and aggregate for credit decisions would generally be subject to the FCRA, there are concerns that such data may not be reliable because they have not been collected property or tested sufficiently.[221] Intuitively, financial data would

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[216] Robert Clark, *et al.*, *Digital Lenders Price Loans Inside a Black Box of Alternative Data*, S&P GLOBAL MARKET INTELLIGENCE, Nov. 8, 2018, https://www.spglobal.com/marketintelligence/en/news-insights/trending/uqhH3EPcmILf4T4S4dQmGg2.

[217] Robert Bartlett, *et al.*, *Consumer-Lending Discrimination in the Fintech Era*, NAT'L BUREAU OF ECON. RESEARCH WP 25943, at 4 & 36 tbl. 3 (June 2019), https://www.nber.org/digest/oct19/minority-borrowers-pay-more-even-under-algorithmic-lending.

[218] FCRA section 607(b) (15 U.S.C. § 1681e(b)).

[219] FCRA section 615(a) (15 U.S.C. § 1681m(a)).

[220] FCRA section 611(a) (15 U.S.C. § 1681i(a)); 12 C.F.R. § 1022.43.

[221] *See, e.g.*, Mikella Hurly & Julius Adebayo, *Credit Scoring in the Era of Big Data*, 18 YALE J. OF L. & TECH. 152-53 (2017), https://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=1122&context=yjolt ("[T]hese new tools

seem more accurate than non-financial data. Most notably, FinTech companies have explored the use of cash-flow data and, as discussed above, early results suggest that they can be accurate, non-discriminatory, and beneficial to financial inclusion.[222] Other types of financial information that could be used to evaluate creditworthiness include payments related to utilities (*e.g.*, electric or gas), telecommunications (*e.g.*, telephone, internet, cable), rental housing, short-term installment loans, and other small-dollar or payday loans. Frequently discussed types of non-financial data include information about consumers' education, occupation, social media use (including about a consumer's friends and contacts), geographic location, and other behavioral data such as internet browsing history, where they shop, what they purchase, and what mobile devices they use.[223] All these financial and non-financial data can be challenging to furnish or collect consistently and may require assessing, among other things, whether the type of data or their sources skew towards certain consumers.[224] For these reasons, the Taskforce elsewhere recommends that the Bureau study whether alternative data in consumer reports are accurate and whether they are furnished consistently such that consumers with similar payment history or other attributes would have similar information appear on their consumer reports.

Concerns have been raised about whether some alternative data raise broader consumer protection concerns. For example, state and local laws may prohibit electric or gas utilities from shutting off service in certain circumstances, such as during winter.[225]

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hold the risk that even the most careful consumers could fall victim to flawed or inaccurate data. The problem of inaccuracy has long proved a challenge for traditional credit-scoring systems, which utilize a relatively limited set of data points. Big-data credit-assessment tools are likely to compound this problem.") (internal citations omitted); U.S. Gov't Accountability Office, *Financial Technology: Agencies Should Provide Clarification on Lenders' Use of Alternative Data*, GAO-19-111, at 37 (Dec. 2018), https://www.gao.gov/assets/700/696149.pdf (summarizing interviews with industry members and stating that, "[s]ix industry stakeholders stated that ensuring many forms of alternative data are accurate without validation of the reliability of the data sources is difficult"); Nat'l Consumer L. Ctr., *Big Data: A Big Disappointment for Scoring Consumer Credit Risk*, at 14-27 (Mar. 2014), https://www.nclc.org/images/pdf/pr-reports/report-big-data.pdf.

222 *See* Section IV.B.2. of this Chapter.

223 See Examining the Use of Alternative Data in Underwriting & Credit Scoring to Expand Access to Credit: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech., at 6-8 (July 25, 2019) (testimony of Chi Chi Wu, Nat'l Consumer L. Ctr.), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-wuc-20190725.pdf.

224 *See* Warren E. Agin & Aki Estrella, *The Biggest Data: Advising Clients about Alternative Lending Models and the Regulatory Scrutiny They Generate*, AM. BAR ASSOC., Aug. 15, 2019, https://www.americanbar.org/groups/business_law/publications/blt/2019/08/alt-lending-models/.

225 See Examining the Use of Alternative Data in Underwriting & Credit Scoring to Expand Access to Credit: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech., at 5 (July 25, 2019) (testimony of Chi Chi Wu, Nat'l Consumer L. Ctr.), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-wuc-20190725.pdf.

Discrimination Concerns and ECOA

With respect to credit transactions, ECOA prohibits discrimination on the basis of several protected classes—most notably race, color, religion, national origin, sex, marital status, or age.[226] As implemented by Regulation B, ECOA prohibits both disparate treatment and facially neutral practices that have a disparate impact on a protected class. Notwithstanding such a disparate impact, however, a creditor may continue a practice if it "meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact."[227]

Some types of alternative data, especially non-financial data, raise ECOA concerns because they may correlate with protected classes and bear no obvious relationship to creditworthiness.[228] Some types of data might simultaneously provide useful information about credit risk but could disproportionally impact protected classes. For example, although one may believe there are legitimate reasons for using a consumer's social media history or educational background, as discussed above, they may serve as a proxy for a prohibited basis. And even otherwise nondiscriminatory data could be problematic depending on how it is collected—drawing from an imbalanced or flawed dataset could lead to disparities in lending decisions.[229]

AI and machine learning-based underwriting algorithms raise complicated fair lending issues that may be difficult to resolve. The sheer number of variables and their combinations—hundreds or potentially thousands—they use makes it extremely difficult to determine the predictive value or potentially discriminatory impact of particular data points.[230] Moreover, machine learning tools are designed to constantly "learn" and improve their models, such that there may be no static underwriting formula for institutions or regulators to evaluate. The Treasury Department thus observed that "applying traditionally accepted practices of model validation and back-testing may be challenging" and that "[m]achine learning based models that

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[226] 15 U.S.C. § 1691(a).

[227] 12 C.F.R. part 1002, comment 1002.6(a)-2.

[228] U.S. Gov't Accountability Office, *Financial Technology: Agencies Should Provide Clarification on Lenders' Use of Alternative Data,* GAO-19-111, at 30-35 (Dec. 2018), https://www.gao.gov/assets/700/696149.pdf; *Examining the Use of Alternative Data in Underwriting & Credit Scoring to Expand Access to Credit: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech.,* at 4-8 (July 25, 2019) (testimony of Chi Chi Wu, Nat'l Consumer L. Ctr.), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-wuc-20190725.pdf.

[229] See e.g. Id.

[230] *See* Robert Clark, *et al., Digital Lenders Price Loans Inside a Black Box of Alternative Data,* S&P GLOBAL MARKET INTELLIGENCE, Nov. 8, 2018, https://www.spglobal.com/marketintelligence/en/news-insights/trending/uqhH3EPcmILf4T4S4dQmGg2.

require significant amounts of data would generally suffer from the absence of past credit-cycle data to 'train' the model."[231]

Some experts warn that the complexity of machine learning-based algorithms may mask their reliance on proxies that are highly correlated with protected classes.[232] AI derives complex statistical models by finding links between the inputted data and various target variables or outcomes. As Professors Schwarcz and Prince describe the abstract concept, its goal is to find such links, and it "entirely ignores potential explanations for these relationships. . . . For this reason, the ultimate statistical models that [artificial intelligence] derive are often nearly impossible to explain intuitively; the models work, but no one—including the programmer, the firm that relies on it, or the [artificial intelligence] itself—can explain why or how it does so."[233] Furthermore, they contend, proxy discrimination may be "virtually inevitable" whenever a prohibited characteristic (*e.g.*, race) has predictive power that cannot be measured more directly by facially neutral data.[234] Unless programmed to avoid such outcomes, AI may search for data relationships that replicate as closely as possible the predictive power of the prohibited characteristic—that is, for proxies.

Improvements in market practices also hold significant promise. Creditors, data aggregators, and CRAs have regulatory and market incentives to produce better data and models that are more predictive of credit risk, minimally correlated with protected classes, and derived from robust and complete datasets.[235] Algorithmic approaches, such as adversarial de-biasing, may enable algorithms to better account for bias within models, though some of these methods have an uncertain status under ECOA.[236] And market participants such as IBM and Microsoft have

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[231] Treasury FinTech Report, *supra* note 124, at 137.

[232] Daniel Schwarcz & Anya Prince, Proxy Discrimination In The Age Of Artificial Intelligence And Big Data, 105 Iowa. L. Rev. 1257, 1273-76 (2020); Examining the Use of Alternative Data in Underwriting & Credit Scoring to Expand Access to Credit: Hearing Before the H. Comm. on Fin. Servs. Task Force on Fin. Tech., at 12 (July 25, 2019) (testimony of Kristin N. Johnson, Tulane Univ. Law Sch.), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-johnsonk-20190725.pdf.

[233] Schwarcz & Prince, 105 IOWA. L. REV. at 1274.

[234] Schwarcz & Prince, 105 IOWA. L. REV. at 1273, 1276.

[235] Warren E. Agin & Aki Estrella, *The Biggest Data: Advising Clients about Alternative Lending Models and the Regulatory Scrutiny They Generate*, AM. BAR ASSOC., Aug. 15, 2019, https://www.americanbar.org/groups/business_law/publications/blt/2019/08/alt-lending-models/.

[236] Joyce Xu, *Algorithmic Solutions to Algorithmic Bias: A Technical Guide*, Towards Data Sci., June 18, 2019, https://towardsdatascience.com/algorithmic-solutions-to-algorithmic-bias-aef59eaf6565. Adversarial de-biasing involves using a training dataset to develop two models: the first model uses various factors to predict creditworthiness, and the second looks at outcomes from the first model and attempts to determine the race (or other protected class) of each borrower. The first model can be continually tweaked until the second model is no longer

created free, open-source toolkits that attempt to evaluate and correct for bias in algorithms.[237] As in other areas of innovation, these market developments, if combined with the Bureau's robust and judicious guidance, could help foster competition and inclusion in consumer financial services.

In short, innovation has delivered significant benefits to consumers of financial services. Although always unpredictable, it holds potential to make those services more valuable, affordable, and accessible than they are today. Innovation also presents challenges for service providers, regulators, and consumers themselves. If those challenges are approached with a reasoned application of the purpose and objectives of the Bureau, there is reason for optimism that innovation will continue to improve the financial lives of consumers.

able to the predict the consumer's race, at which point the first model has been "de-biased." Given the explicit use of race and other prohibited factors, there are questions about how creditors could use adversarial de-biasing consistent with ECOA's protections.

[237] IBM Research, AI Fairness 360, https://aif360.mybluemix.net/ (last visited Nov. 11, 2020); Sarah Bird, *et al.*, *Fairlearn: A Toolkit for Assessing & Improving Fairness in AI*, Microsoft, Sept. 22 2020, https://www.microsoft.com/en-us/research/uploads/prod/2020/05/Fairlearn_WhitePaper-2020-09-22.pdf.

10. Access and inclusion

Increasing financial access and inclusion is a moral imperative. All Americans should have access to an array of product choices offered in competitive and transparent markets with prices and terms set through the voluntary exchange of willing providers and willing demanders. Low-income and young consumers, minorities, citizens and residents, men and women—Americans of all races, beliefs, and identities have an inalienable right to be treated with dignity and respect, to be protected from discrimination, and to be respected to make informed choices that they consider to be best for them under the circumstances they face. Increased financial access to sustainable credit is also sound policy that promotes household financial security, economic empowerment, and macroeconomic growth and stability.

Financial inclusion also presents distinct policy challenges. In many instances the circumstances that low-income, young, minority, and immigrant households face are very different from those of the average American household. And the needs and circumstances of individuals within every group can be highly heterogeneous as well.

In the modern economy, access to financial products and services is a necessary ingredient to improving one's life, health, and well-being. Consumer access to bank accounts, savings accounts, mortgages, student loans, auto loans, credit cards, retirement accounts, and other financial products are vehicles to build wealth, provide financial security, and acquire the personal capital that provides the raw material for economic success and human flourishing. Those who are excluded from the financial system are excluded from those benefits; indeed, they are unable to gain the first toehold on the economic ladder that will pull them into the middle class.

Today, unlike even 50 years ago when the National Commission on Consumer Finance (NCCF) reviewed the consumer finance landscape, we live in an era in which hundreds of millions of Americans take for granted the ability to access a wide array of high-quality financial services available 24-hours a day from the convenience of their computer or phone. Most American families have dozens of financial providers offering quality, innovative solutions to their financial needs, and new innovations are arriving every day. As author Lewis Mandell has observed, “With a credit card, you can buy yourself a new car. Without it, you cannot even rent one.”[1]

But today, a minority of the population remains outside the mainstream financial system, unable to access the first rung on the ladder to financial inclusion and empowerment. In many instances, consumers desire access to financial products but are unable to find them, cannot qualify for them, find them too expensive or otherwise unavailable. Whether a result of prohibited discrimination, a market failure, or consequence of government regulations, credit that they can afford but cannot obtain is harmful to consumers. Although largely invisible to middle-class Americans, these impediments provide daily hurdles to greater financial access for millions of minority, younger, women, and immigrant consumers.

Providing access to quality financial services at reasonable prices was one of the four great themes of the NCCF Report, along with competition, consumer protection, and promoting informed consumer choice.[2] The NCCF concluded that the primary barriers to more widespread financial inclusion were government regulations and limits on competition and entry that interfered with the ability of companies to voluntarily transact with a wider array of consumers in a competitive market. Foremost among those barriers were long-standing legal restrictions on permissible interest rates, so-called “usury” ceilings and accompanying regulatory barriers to entry.

In the period since that time, the financial system made great strides in expanding access to individuals and groups who were unable to gain access to quality financial services in the past. In predominant part, this growth in access arose from reforming or eliminating many of the historical regulatory barriers that stood in the way of financial institutions providing access to financial products. Once those barriers were eliminated or attenuated, market forces naturally drove a process of seeking out new customers. Technological innovations, most notably the evolution of credit reporting, helped financial services providers to identify new groups of underserved consumers. Finally, federal legislation, regulation, and enforcement in the area of fair lending were designed to root out areas of discrimination.

The Taskforce notes at the outset that an important topic that is not discussed in detail here are the financial challenges of rural populations. Bureau research has found that rural populations

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[1] Lewis Mandell, The Credit Card Industry: A History at xi (1990).

[2] *See* National Commission on Consumer Finance, Consumer Credit in the United States (Dec. 1972) (hereinafter, “NCCF Report”).

are the geographic group with the highest rate of credit invisibility.[3] The challenges of financial inclusion for rural populations has grown in recent years as many rural bank branches have been closed, leaving the next closest bank many miles away.[4] Moreover, many rural areas still have limited and expensive internet access and may lack reliable mobile phone service.[5] Issues involving the financial inclusion of rural communities is a topic worthy of greater study.

This chapter surveys all of the forces that influence access and inclusion. We start by examining the underlying dynamics that drive the challenge of financial inclusion. We then review the history of financial inclusion in the United States and traditional economic and regulatory barriers to greater financial inclusion. This discussion builds on Chapter 5's discussion of small-dollar loans and credit rationing. For much of American history, upper-class and wealthy elites have been skeptical of the value of financial inclusion for non-elite, working-class individuals. Working-class individuals were seen as profligate, impulsive, and easily tempted into living beyond their means. Crude and unfounded stereotypes based on class, race, and sex were invoked to support paternalistic protections on categories of consumers. Eliminating these barriers and the stereotypes that rationalized them was a primary focus of the NCCF Report and remain a focus of this report.

Finally, the chapter turns to examine the current state of affairs, focusing particularly on the impact of legislative and regulatory actions taken in the period following the 2008 financial crisis and closing with a discussion of steps policymakers could take to promote greater inclusion, access, competition, and innovation.

10.1 Financial Inclusion and Its Limits

Expanding access to financial services has long been understood as a primary goal of government policy. As noted by the NCCF, one of the vital roles of the legislator in the area of consumer credit is "to assure access *by all*" to various credit offered in competitive markets.[6] This mandate is codified in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in the "Objective" that the Consumer Financial Protection Bureau (CFPB or

[3] *See* Bureau of Consumer Financial Protection Office of Research, Data Point: the Geography of Credit Invisibility (Sept. 2018).

[4] *See* Federal Reserve Board, Perspectives from Main Street: Bank Branch Access In Rural Communities (Nov. 2019). Also see Chapter 8, which discusses trends in concentration and obstacles to entry in smaller markets.

[5] Id.

[6] NCCF Report, *supra* note 2, at 2.

Bureau) should ensure that "markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation."[7] In addition, in any rulemaking the Bureau is instructed to consider the "potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule."[8]

10.1.1 What is Financial Inclusion?

"Financial inclusion" and "financial access" are terms and concepts that are often invoked but not always well defined. The World Bank provides a useful working definition:[9]

Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs—transactions, payment, savings, credit and insurance—delivered in a responsible and sustainable way.

Being able to have access to a transaction account is a first step toward broader financial inclusion since a transaction account allows people to store money, and send and receive payments. A transaction account serves as a gateway to other financial services ...

In the United States, access to a "transaction account" traditionally has required a bank account. Beyond access to bank accounts, financial inclusion usually also means access to mainstream consumer financial products, such as credit cards, auto finance, and mortgage credit. But technological innovation is challenging this traditional intuition, as FinTech products increasingly supplant the roles played by many of the familiar instruments, creating an opportunity for the development of highly personalized products tailored to specific consumer's needs and preferences. Unconstrained by the traditional cost structure and limits of geographic proximity to customers, FinTech products bring the dynamics of "the long tail" to consumer financial products just as the internet has to other products, allowing the development of more tailored product offerings that belie the traditional lumpy distinction between "inclusion" and "exclusion" or "mainstream" and "alternative" products. This suggests a broader and more nuanced understanding of financial inclusion may be appropriate in the future beyond simply having a bank account.

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[7] 12 U.S.C. §5511(b).

[8] 12 U.S.C. §5512(b)(2)A)(i).

[9] World Bank, Financial Inclusion: Overview, *available in* https://www.worldbank.org/en/topic/financialinclusion/overview.

It is not necessary for the Taskforce to resolve the question of how to define "financial inclusion" or how it is best measured. For working purposes, it is sufficient to adopt a definition similar to that suggested by in Chapter 5 in discussing credit rationed consumers—"financial inclusion" refers to a situation in which a consumer's access to reasonable and sustainable financial products is unrationed and an array of products are available in a reasonably competitive market. More simply, this definition more or less aligns with the traditional understanding that financial inclusion and access provide consumers with access to mainstream financial products on terms that may be different in degree but not in kind from the types of products used by middle-class households. Nevertheless, for ease of exposition we will use the conventional concepts of "unbanked" to describe those individuals who are outside the mainstream financial system and "alternative" products to describe the products they rely on, although we will return at the end of the chapter to the implications of recognizing a more nuanced approach that analyzes inclusion as more of a continuum.

10.1.2 Determinants of Financial Inclusion

Financial inclusion has unique demand and supply elements that differ from mainstream markets and consumers. Many public policy proposals fail to appreciate these underlying dynamics of the market and thus have often proven either ineffective or even counterproductive at addressing the problem.

Understanding the demand side of the financial inclusion question begins by recognizing that unbanked consumers seek access to financial services for the same reasons as all consumers—to reduce the transaction costs of engaging in every day commercial transactions (by having access to a bank account or some other transaction account), to exploit useful investment opportunities by shifting the time of purchases (especially the purchase of consumer durable goods such as automobiles and household appliances, housing, and human capital investments such as education and training), to use credit or savings to meet short-term imbalances between income and expenses, to save, and to smooth long-term consumption over their lifecycle.[10] Behavior that looks puzzling or irrational to financially established, upper-middle class, professional households might actually simply reflect different but rational choices made by lower-income consumers facing different constraints. As economist Jan Newton concluded in her study of "The Economic Rationality of the Poor" in 1977, "[P]oor people do perceive and act in

[10] *See* Theodore W. Schultz, *Nobel Lecture: The Economics of Being Poor*, 88 J. Pol. Econ. 639, 649 (1980) (concluding "poor people are no less concerned about improving their lot and that of their children than those of us who have incomparably greater advantages. Nor are they any less competent in obtaining the maximum benefit from their limited resources"); *see also* Jan M. Newton, *Economic Rationality of the Poor*, 36 Human Organization 50, 58 (1977) (concluding that "low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans").

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accordance with marginal costs and returns ... they make the most of what they have. They are ... close to their optimum *given their circumstances*, which is the most we can say of anybody."[11] For these consumers who seek access to mainstream financial products but are unable to obtain it, constraints on financial inclusion are primarily a function of supply-side forces. Consequently, promoting financial inclusion should focus on the supply side of the market.

Some who remain outside the mainstream financial system do so by choice. They do so for a variety of reasons, but in many cases, they have negative subjective views of many financial providers either shaped by a general sense of distrust or negative personal experiences with certain providers that have soured them. Sometimes, these conclusions might be amenable to reconsideration through financial education programs, products, or providers that can build trust or are better designed to meet an individual's needs.[12]

The supply side of the financial inclusion challenge is determined by the cost and risk of providing financial services to traditionally underserved consumers. Lower-income and higher-risk consumers can be costly to service because they can only qualify for small amounts of credit, and the cost of providing products and services does not scale proportionately to the size of the credit extension. Lower-income consumers also tend to be less-profitable for banks because they hold smaller deposit balances and are less likely to use lending products such as credit cards, car financing, mortgages, and home equity loans that can produce additional revenue for the provider. Ensuring that providers have adequate incentives to serve lower-income consumers is an essential element of increasing access and inclusion.

As the 2008 financial crisis illustrates, however, financial inclusion does not mean extending credit to a consumer who lacks the ability to repay it or offering financial products that are

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[11] Newton, *supra* note 10, at 58 (emphasis added). Newton also notes that if researchers "assume that low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans, a different research focus emerges. For if people seem to act less than optimally, the research question become these: what are their *resources* and what *constraints* impinge on them?" *Id.*

[12] In other instances, voluntary use of alternative financial products is driven by less-benign motives, such as to conceal illegal activity, status, or financial transactions, or to avoid court-mandated garnishment or spousal support obligations. It is unlikely that alternatives for these consumers are likely to change through greater use of financial education or policies designed to increase the supply of financial products. Discussion of these rationales for choosing to remain outside the mainstream financial system are beyond the relevance of the Taskforce's mission but bear additional research. *See, e.g.*, Thomas J. Miles, *Markets for Stolen Property: Pawnshops and Crime*, working paper (Jan. 24, 2008), *available in* https://www.law.umich.edu/centersandprograms/lawandeconomics/workshops/Documents/Winter2008/miles.pdf ; John Crudele, *State, City Eye Shady Use of Check-Cashing Firms*, N.Y. Post (Jan. 7, 2010) (discussing New York City and State investigations into use of check-cashing firms to evade tax obligations); Jon Prior, *Banking From the Shadows: Does the Texas Banking Industry Discourage Undocumented Customers? The Answer Might Surprise You*, Dallas Business Journal (Dec. 7, 2016), *available in* https://www.bizjournals.com/dallas/news/2016/12/07/banking-from-the-shadows-does-the-texas-banking.html (noting that many illegal immigrants avoid interacting with the banking system and use alternative service providers because of fear of being discovered).

unsuitable for a consumer's financial circumstances, which can result in default and additional harm to a consumer, such as a damaged credit score, loss of collateral, or even lawsuits and bankruptcy. Thus, the challenge of financial inclusion should be recognized as a tradeoff between avoiding the extension of credit to uncreditworthy consumers on one hand and simultaneously avoiding incorrectly denying credit to creditworthy consumers on the other. "An excessive focus on avoiding Type I error leads to an undersupply of credit and a considerable underserved population. On the contrary, an excessive focus on avoiding Type II error leads to an oversupply of credit, causing a higher default rate as witnessed in the 2008 subprime mortgage crisis."[13]

10.2 Historical Causes and Consequences of Financial Exclusion

For most of history (predating the formation of the United States) credit use was viewed with suspicion, and government policy was typically intended to discourage access and use of credit by all but the wealthy. This skepticism was rooted in the notion that a fundamental distinction could be drawn between use of credit for business and commercial purposes (often characterized as "productive" borrowing) versus use of credit for consumer purposes (which was seen as purely for consumption) as well as the low esteem held by elites for the character and financial habits of the lower classes. Much of this skepticism was class-based; still other aspects of it were grounded in stereotypes about the believed capacity among some demographic groups to use financial services wisely and to resist the lure of immediate gratification.[14]

Consumer credit was not particularly well-developed or widespread during the 19th century, although retailers in urban neighborhoods and agricultural areas often provided credit to customers in a temporary bind and to farmers needing a bridge until the harvest arrived.[15]

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[13] Hongchang Wang, Chunxiao Li, Bin Gu, Wei Min, *Does AI-Based Credit Scoring Improve Financial Inclusion? Evidence from Online Payday Lending* at 1 (ICIS 2019 Proceedings, 2019), *available in* https://aisel.aisnet.org/icis2019/blockchain_FinTech/blockchain_FinTech/20/#:~:text=Artificial%20intelligence%20(AI)%20has%20become,in%20the%20consumer%20finance%20industry.&text=Using%20data%20obtained%20from%20these,the%20quality%20of%20financial%20inclusion.

[14] *See* discussion in Newton, *supra* note 10, at 51 (describing prevailing stereotypes of the economic behavior of lower-income individuals).

[15] *See* National Commission on Consumer Finance, Consumer Credit in the United States 5 (1972) ("The image of the sturdy, self-reliant, resourceful pioneer who always paid cash for/ his staples and his tools may be the one imparted by some accounts of early colonial life, but it is not entirely accurate. Retail credit was available to farmers on a crop-to-crop basis. When they were short on cash, they did as many consumers do today—they traded their expectations of future income for goods and services from local merchants.").

Installment lending to finance consumer durables, which emerged starting in 1807,[16] was largely reserved for social and commercial elites. As Lendol Calder notes, early access to installment credit was limited to "men with good credit reputations, who had steady jobs, who were rooted in the community, and who were not subject to discrimination based on race and ethnicity."[17] As installment selling spread to cover new products and providers beginning in the late-19th century, it also "spread extensively among marginalized groups."[18] As ordinary Americans gained greater access to credit, "retail installment credit ceased being a novelty and became something of a disgrace."[19] In the eyes of many elites, government officials, and consumer advocates of the era, "[T]he installment plan acquired a reputation for being the folly of the poor, the immigrant, and the allegedly math-impaired female."[20] Animosity toward those providing credit to previously-excluded consumers was often tinged with anti-Semitism and claims that lenders were exploiting vulnerable consumers.[21]

Demand for consumer credit changed dramatically in the late 19th and early 20th centuries as a result of the massive migration of Americans from farms to industrial cities. Urban life and the wage economy brought many Americans face-to-face with new challenges, including periodic unemployment, medical challenges, and in the 20thcentury, a need for appliances necessary for city living, such as refrigerators, stoves, and washing machines. Although retailers would often be willing to extend credit to finance the purchase of appliances and other durables, consumers often also needed access to cash credit to pay for housing, medical care, or food, and to meet unexpected shocks to income or expenses, not just retail credit.

Former Federal Reserve Chairman Alan Greenspan observed of the period from colonial times through the early 20th century that "access to credit for most people was quite limited, and

[16] Edwin R.A. Seligman, 1 The Economics of Instalment Selling: A Study in Consumers' Credit, with Special Reference to the Automobile 42 (1927).

[17] Lendol Calder, Financing the American Dream: A Cultural History of Consumer Credit 166 (2001).

[18] Id.

[19] Id.

[20] Id.

[21] For example, according to economic historian Louis Hyman, Henry Ford originally opposed the sale of Ford vehicles on installment credit, in part because he opposed inducing American workers to send money "back east to bankers" and particularly to "Jewish financiers" who supposedly ran the money markets. Ford believed that owing money to bankers would undermine the spirit of American independence by exposing them to the clutches of those lenders. *See* Louiis Hyman, Borrow: The American Way of Debt 53-55 (2012). Originally Ford offered to allow customers to buy cars on layaway (essentially a "save before you buy" program) but eventually relented to allowing credit sales.

where available at all, quite expensive."[22] He notes, "Only the economic elite were able to obtain personal loans from commercial banks, and then only on an accommodation basis because they were prominent merchants or landowners." Notably, "Commercial banks did not make consumer loans to the general public."[23] One commentator estimated in 1922 that only seven of 100 persons had a bank account and only about 14 percent of the adult population could meet the requirements for underwriting and collateral to be able to borrow money from a bank. Needless to say, this 14 percent of the population was tilted toward the wealthy and well-connected and included very few working-class Americans.[24]

10.3 Credit Supply, Regulation, and Financial Exclusion

Until recently, usury laws were the primary tool used to regulate access to consumer credit. Although supposedly intended to protect consumers, especially lower-income consumers, usury ceilings universally had the opposite effect: reducing access, limiting choice, and stifling competition. In many instances, this lack of access to legitimate credit provision pushed desperate working-class families into the arms of illegal lenders and in the second half of the 20th century, mafia-controlled loan sharks. As discussed in Chapters 4 and 5, it is economically impossible to make small loans profitable at low interest rates. As the NCCF observed, "Because the usury laws that the colonies had inherited from England prevented the granting of cash loans at economically feasible rates, a legal installment loan market was, in essence outlawed."[25] As noted, banks largely served economic elites, in part because they were often governed by strict usury ceilings that made smaller loans uneconomical.

So long as usury ceilings existed, consumers and lenders developed mechanisms to circumvent usury ceilings so that consumers could obtain access to the financial products that they needed. The roundabout and indirect means used resulted in deadweight loss to consumers and lenders,

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[22] Federal Reserve Chairman Alan Greenspan, *Consumer Credit and Financial Modernization* (Oct 11, 1997), *available in* https://www.federalreserve.gov/boarddocs/speeches/1997/19971011.htm.

[23] *Id.*; *see also* NCCF Report, *supra* note 2, at 46 (noting that in the early 20th century "commercial banks were unwilling to enter the consumer credit market, either because of their tradition of lending to commercial institutions or because consumer loans at permissible rates were unprofitable").

[24] J.A. Reichart, *The Loan Shark Still Flourishes*, 3 Brooklyn Chamber of Commerce Bulletin 9 (July 1, 1922) (reprinted from *Forbes' Magazine*).

[25] NCCF, *supra* note 2, at 5; *see also* Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, Consumer Credit and the American Economy 486 (2014).

as they had to use more expensive and 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 that cuts across the other three).[26] These unintended consequences include: (1) term repricing, (2) product substitution, and (3) rationing. In addition, market adjustments taken to circumvent usury ceilings also can have an adverse effect on market competition that is affected by the other behaviors. Finally, usury ceilings and other similar price control regulations often have regressive distributional consequences.

10.3.1 Usury Law and Financial Exclusion

Term Repricing

The first mechanism used by consumers and lenders to circumvent usury restrictions is the practice of "term repricing." As the NCCF found,[27] and has recently been reaffirmed,[28] the equilibrium price of financial services is established by fundamental 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 equilibrium price that prevails in the market and that market prices do not rise to maximum level permitted by law.[29] Where price controls are binding and the price ceiling is set below the market equilibrium price, however, interest rates settle at the statutory cap. In this latter cases, if lenders cannot charge a market rate of interest they can adjust other terms of the loan to try to approximate market clearing terms, such as requiring a down payment (or a larger down payment), 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, and making other adjustments that are designed to implicitly adjust prices to the market-clearing level.[30]

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[26] *See* Todd J. Zywicki, *The Market for Information and Credit Card Regulation,* 28 Banking and Fin. Serv. Pol'y Report 13 (Vol. 1, 2009).

[27] NCCF Report, *supra* note 2, at 96-99.

[28] See Thomas W. Miller, Jr. and Todd J. Zywicki, The Effects on Consumers from State-Level Regulation of the Payday Loan Market (Apr. 30, 2020).

[29] NCCF Report, *supra* note 2, at 99.

[30] *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 is that none really controls the price of money or

Because the costs of lending do not scale proportionally to loan size, lenders can circumvent annual percentage rate (APR) ceilings by increasing the minimum size and lengthening the maturity of a loan.[31] But only lower-risk and higher-income borrowers can qualify for larger loans. Many consumers who are able to qualify at the larger minimum loan size effectively will be forced to borrow more than they would like for a longer period than desired, increasing the risk of financial breakdown. The combination of longer loan maturities and larger loan size could also increase the total finance charges paid over the life of the loan.

A well-known example of usury rate circumvention through term repricing occurred when interest rate ceilings were binding during the 1970s leading credit card issuers to responded by assessing annual fees on cards.[32] Annual fees were regressive in their distributional effect, as most cards assessed the same annual fee regardless of income, borrowing habits, credit line, usage, risk profile, or other factors that would otherwise affect pricing decisions. Banks made credit cards or personal loans preferentially available to those consumers who also purchased other bank products whose prices were less-heavily regulated, which again benefited higher-income consumers.[33] Banks in states with stricter usury ceilings also charged higher service charges on demand deposit accounts and checking account overdrafts to offset their inability to make a normal rate of return on lending operations.[34] These various offsetting adjustments also hampered competition as annual fees operated as a tax on card-switching. Tying access to credit cards to the purchase of additional bank services further reduced competition by raising the costs of changing providers.

In fact, economists have concluded the primary beneficiaries of interest-rate controls were middle-class borrowers, not lower-income borrowers. The application of usury ceilings enabled middle-class borrowers to gain access to credit at below-market rates by making it uneconomical to lend to higher-risk borrowers, diverting lending capital from higher risk to

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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."). To limit loss rates, creditors in states with stricter usury ceilings typically pursue more aggressive collection efforts that elsewhere.

[31] See Thomas A. Durkin, Gregory Elliehausen, Min Hwang, Rate Ceilings and the Distribution of Small Dollar Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders, Working Paper (Dec. 4, 2014), available in https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2533143; see also Paul F. Smith, Pricing Policies on Consumer Loans at Commercial Banks, 25 J. Fin. 517 (1970)

[32] Todd J. Zywicki, *The Economics of Credit Cards*, 3 Chapman L. Rev. 79 (2000).

[33] *See* A. Charlene Sullivan, Evidence of the Effect of Restrictive Loan Rate Ceilings on Prices of Consumer Financial Services (Credit Research Ctr. Working Paper No. 36, 1980).

[34] Zywicki, *Economics of Credit Cards*, *supra* note 32, at 160; Sullivan, *supra* note 33, at 20; Richard L. Peterson & Gregory Falls, Impact of a Ten Percent Usury Ceiling: Empirical Evidence 33 (Credit Research Ctr. Working Paper No. 40, 1981).

lower-risk markets.[35] By limiting the ability to allocate credit through market prices, usury laws instead led to greater reliance on nonprice allocations, such as a prospective borrower's 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). Nonprice rationing also increased the ability to engage in invidious discrimination against groups such as women and minorities who lacked those connections.[36] 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.[37]

Product Substitution

Not all products have a sufficient number of margins that can be adjusted so as to make possible an attractive market for consumers. Annual fees, for example, will increase revenues to offset lost finance charges, but annual fees 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.

Where term repricing is inadequate to enable certain products to be supplied in a quantity and on terms that can meet demand, higher-risk consumers will be forced to substitute alternative products for their preferred choice. Eliminating the supply to consumers of a particular product (such as credit cards) does not eliminate the underlying consumer demand for credit. Through the 1970s, the most obvious form of product substitution was toward retail store credit because of the ease by which retailers could circumvent usury laws by bundling the provision of credit with the sale of goods and marking up the price of the goods that they sold to offset their credit losses.[38] As discussed in Chapter 3, durable goods that provide a return over time emerged very early 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.[39] 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

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[35] *See* William J. Boyes, *In Defense of the Downtrodden: Usury Laws*, 39 Pub. Choice 269 (1982).

[36] See Efraim Benmelech and Tobias J. Moskowitz. The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century, 65 J. of Finance 1029 (2010).

[37] *See* Boyes, *supra* note 35.

[38] *See* NCCF Report, *supra* note 2, at 105-07; Gene C. Lynch, *Consumer Credit at Ten Percent Simple: The Arkansas Case*, 1968 Illinois L. Forum 592 (1968).

[39] *See* Wheatley & Gordon, *supra* note 30, 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%).

the price of the goods they sold.[40] As a result, cash purchasers were forced to pay a higher price to subsidize credit purchasers who were able to pay below-market prices for the credit element of their transactions.[41] Moreover, retailers typically did not limit price increases to products usually sold on credit but increased the prices on all goods.[42] As a result, cash purchasers who were unable to qualify for credit or unwilling to pay the higher credit price to buy on time were forced to subsidize credit purchasers.[43]

A 1979 study by Dunkelberg and DeMagistris illustrated the product substitution response to state usury ceilings.[44] They examined the composition of consumer credit in a state with a low maximum interest rate ceiling (Arkansas) with two states with higher ceilings (Wisconsin and Louisiana). They found that although the total amount of credit held by consumers in all the states was approximately equal, the composition among them differed. For example, 49 percent of all consumer credit outstanding in Arkansas was through retail providers (such as department stores) versus 29 percent in Wisconsin and Louisiana. Banks, finance companies, and credit unions provided only 51 percent of credit in Arkansas versus 67 percent in higher-cap states. Whereas 28 percent of consumers reported having been turned down for credit in Arkansas, only 12 percent reported the same in Louisiana. And Arkansas consumers were also

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40 *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 2, at 107, 145-46, and Table 7-18 (discussing National Retail Merchants Association study).

41 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.

42 Wheatley & Gordon, *supra* note 30, 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..."). Moreover, the Truth in Lending Act discourages charging different retail prices for cash and credit purchases; the price difference must be disclosed as part of the finance charge, which is likely to raise the interest rate above the rate cap.

43 NCCF Report, *supra* note 2, at 106; *id.* at 113.

44 William C. Dunkelberg and Robin DeMagistris, *Measuring the Impact of Credit Regulation on Consumer*, *in* The Regulation of Financial Institutions: Conference Series No. 21, at p. 44 (1979).

more likely than residents of higher-cap states to say that retailers were the easiest place to get credit.[45]

Retailers' circumvention efforts benefited from preferential legal treatment. 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."[46] Courts reasoned, "somewhat implausibly,"[47] that the "time price" was simply an offer to the buyer of a different price for the goods and not a loan.[48] Thus, whereas those who offered cash credit (such as 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" that exceeded the cash price and which had an implicit, but unregulated, interest rate built in.[49]

Induced tying of transactions in goods together with the provision of credit to circumvent usury ceilings also dampened competition in both markets to the detriment of consumers.[50] Bundling sale of the goods together with credit also made prices less transparent for both items, making comparison shopping more difficult. The task of deciding between competing offers where one term offers a lower product price and the other offered a lower APR could be challenging for most consumers. In making the joint purchase decision, consumers naturally focused on the cost and quality of the goods purchased more than the credit element, which dampened comparison shopping.[51] In states with higher legal rate ceilings, by contrast, lenders were more

[45] A 1981 study by Peterson and Falls compared borrowers in Arkansas with borrowers in states with less restrictive rate ceilings and similarly found that Arkansas consumers obtained the same amount of credit in total as those in other states, but they acquired a larger percentage of their credit from retailers. They also found 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. Peterson and Falls, *supra* note 34.

[46] *See* Durkin, Et al., *supra* note 25, at 487.

[47] Id.

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

[49] 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,but 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.*

[50] NCCF Report, *supra* note 2, at 123-28.

[51] NCCF Report, *supra* note 2, at 181.

likely to include information about finance charges in their advertising copy, which suggests greater competition for higher risk borrowers in those states.[52]

One major reason for the rapid growth of general purpose credit cards in the post-*Marquette* era (aside from the benefits they provided to consumers) was the opportunity that bank-type cards provided retailers, especially smaller retailers, to outsource the cost and risk of operating credit operations onto banks.[53] In so doing, bank cards also eliminated a competitive disadvantage for smaller retailers seeking to compete against larger department store chains, which could more easily bear the expense and risk of providing their own in-house credit operations.[54]

More recent studies reveal the fashion in which binding usury ceilings induce product substitution. A 2017 study by Melzer and Schroeder examined the impact of state usury ceilings on automobile financing.[55] They found that in states where auto credit interest rate ceilings are binding, automobile dealers provided a higher percentage of car-loan financing, especially for riskier borrowers. They also found that the size of the loans and the loan-to-value ratio of loans made through dealers were higher than those by non-dealers. This suggests that in order to sell cars to credit-rationed consumers, auto dealers were more willing than banks and credit unions to extend credit to riskier consumers.[56]

Product substitution as a result of interest rate ceilings was not limited to greater use of retail credit. While retailers filled the gap for purchase of goods, they did not provide cash loans. 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 states with less restrictive usury ceilings.[57] Pawn shops often operated under distinct rules that permitted higher

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[52] *See* Smith, *supra* note 31, at 520.

[53] 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.

[54] National Retail Merchants Association, *supra* note 40, at 51-52.

[55] Brian Melzer and Aaron Schroeder, *Loan Contracting in the Presence of Usury Limits: Evidence from Automobile Leasing*, Consumer Financial Protection Bureau Office of Research Working Paper No. 2017-02 (March 2017).

[56] 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 30, at 24.

[57] *See* Peterson & Falls, *supra* note 34, 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 (1982). The impact in Arkansas was not just felt with credit cards. As economist Richard Rahn testified in Congress in 1983, "Arkansas' 10-percent ceiling for instance, caused every personal loan company to leave the state when interest rates rose after 1977." Statement of Richard W. Rahn on "The Credit Deregulation and Availability Act of 1983," Hearing Before the United Senate Committee on Banking, Housing, and Urban Affairs (Apr. 12, 1983) at 56.

interest rates than other types of loans and could circumvent even those limits by discounting the value they offered for the goods pledged. Recent research has found that similar product effects persist today. For example, regulatory bans on payday loans prompt payday loan customers to shift to greater use of pawn shops,[58] overdraft protection,[59] or alternatives such as bounced checks and late bill payments.[60] Similarly, as discussed below, reduced access to credit cards by higher-risk consumers as a result of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act) pushed many of those consumers to greater reliance on personal finance installment loans.[61]

Rationing and Illegal Lending

A third effect of usury regulation is rationing – denying credit to creditworthy applicants. 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 legal credit available, some consumers will experience unmet demand for credit. Rationing of credit can occur either by lending less to all or most borrowers (by reducing available credit lines) or eliminating or reducing lending to higher-risk borrowers. Smaller loans, which have higher measured APRs, will be expected to disappear from the market entirely.[62] As the NCCF observed, rate ceilings "may allow some better credit risks to pay less... but only at the expense of the higher risk borrowers who are excluded from the market."[63]

Limiting the supply of credit does not eliminate the demand—which sometimes has been satisfied by illegal lending (i.e., "loan sharks"). As the NCCF noted in 1972, although usury ceilings eliminated supply, "Since the need for small cash credit nonetheless existed, a

[58] *See* Neil Bhutta, Jacob Goldin, and Tatiana Homonoff, *Consumer Borrowing After Payday Loan Bans*, 59 J. L. & Econ. 225 (2016).

[59] *See* Donald Morgan, Michael Strain, and Ihab Seblani, *How Payday Credit Access Affects Overdrafts and Other Outcomes*, 44 J. of Money, Credit, and Banking 519 (2012); Brian T. Melzer and Donald P. Morgan, *Competition and Adverse Selection in the Small-Dollar Loan Market: Overdraft versus Payday Credit*, Federal Reserve Bank of New York Staff Report No. 391 (2009).

[60] See Jonathan Zinman, Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap, 34 J. of Banking and Fin, 546 (2010).

[61] *See* Gregory S. Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, 34 J. of Fin. Intermediation 109 (2018).

[62] *See* Durkin, *supra* note 25, at 500-501.

[63] NCCF Report, *supra* note 2, at 104; *see id.* at 136 ("Legal rate ceilings may reduce the price of personal loan credit to some borrowers, but when ceilings are sufficiently low to affect the observed market rate in a significant way, there is a substantial reduction in the number of borrowers included in the legal market. Relatively low risk borrowers who remain in the legal lending market appear to benefit from the lower cost loans made when higher risk potential borrowers are excluded. There is no such trade-off when it comes to the impact of competition.").

flourishing illegal market developed."[64] As the NCCF observed, "Before development of licensed consumer finance companies between 1910 and 1930, the loan shark was probably the most common source of credit for the wage earner. Loan sharking prospered because legitimate lenders could not profitably lend to consumer borrowers under the low usury law ceilings."[65]

Former Federal Reserve Chairman Alan Greenspan observed, "[o]ne study estimated that in American cities with populations of over 25,000, about one family in five was the victim of loan sharks."[66] Greenspan described the plight of these borrowers in thrall to illegal lenders for "burdensome payments" as a condition of "virtual serfdom."[67] It is estimated that, in 1911, 35 percent of New York City's employees owed money to illegal lenders.[68] Not all illegal lenders were violent loan sharks, however; many simply lent at rates that exceeded statutory rate ceilings and were otherwise open and notorious. In Chicago in 1916, for example, there were 139 active loan offices, all of which were illegal.[69]

Later in the 20th century, however, loan sharking operations became the province of organized crime, which enforced its racket by threats of physical violence.[70] For obvious reasons, the size of the illegal criminal loan shark racket has been difficult to measure.[71] 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 2020 dollars, adjusted for inflation.[72] For purposes of comparison, that estimated market size is about twice the size of the estimated $32 billion payday loan market (storefront and online

[64] NCCF Report, *supra* note 2, at 5.

[65] *Id.*; *see also* Reichart, *supra* note 24, at 15 ("The intent [of these laws], of course was good, but the effect was to more firmly entrench the loan shark. The borrower had to have the money, but could not get it under the law. So he went about the matter clandestinely and was charged an even higher rate than he would have had to pay were there no anti-loan shark law in the state, because of the extra hazard the lawn shark incurred in transgressing the law.")

[66] Greenspan, *supra* note 22.

[67] *Id.*; *see also* NCCF Report, *supra* note 2, at 46 (from 1880 to 1920 "urban America became the illegal lender's paradise").

[68] *See* Rowena Olegario, The Engine of Enterprise: Credit in America 108 (2016).

[69] Irving S. Michaelman, Consumer Finance: A Case History in American Business 110 (1966)

[70] *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). Violent loan sharks tied to organized crime became more prominent in the second half of the 20th century.

[71] *See* Todd J. Zywicki, *The Sanders-AOC Protection for Loan Sharks Act*, RealClearPolitics.com (June 9, 2019), https://www.realclearpolitics.com/articles/2019/06/02/the_sanders-aoc_protection_for_loan_sharks_act_140472.html.

[72] Ralph Salerno, The Crime Confederation: Cosa Nostra and Allied Operations in Organized Crime (1969).

combined) in the United States today.[73] 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.[74] 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.[75]

This connection between unreasonably low interest rates, the elimination of legal small-dollar lending, and the presence of loan sharks was captured in a 1964 statement by New York Senator-elect Robert F. Kennedy submitted to the New York State Legislative Committee investigation of organized crime, which urged "altering the state laws on usury so an insolvent person who needs money for legitimate purposes might borrow it at rates that were not exorbitant."[76] By 1968 the loan shark problem was so notorious in so many cities that Richard Nixon highlighted the issue in his speech accepting the Republican Party nomination for President that year and even rebroadcast his pledge to attack the loan-shark problem in television ads.[77] There is little reason based on economic theory or historical evidence to believe eliminating the supply of legal credit will eliminate the demand.

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73 *See* Eric Wilson and Eva Wolkowitz, *2017 Financial Underserved Market Size Study,* Center for Financial Services Innovation (Dec. 2017), https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2017/04/27001546/2017-Market-Size-Report_FINAL_4.pdf.

74 *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).

75 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).

76 Inquiry is Begun on Loan Sharks: Underworld's Investment in Racket is Put at Billion, New York Times (Dec. 2, 1964).

77 *See* Walter D. Malcolm and John J. Curtin, Jr., *The Federal Attack on the Loan Shark Problem,* 33 Law & Contemp. Problems 765, 765 (1968).

10.3.2 The Elimination of Usury Laws and Growing Financial Inclusion

Recurrent problems of usury laws including evasions, high cash prices for goods purchased on credit, lack of transparency, regressive term substitution, rationing, and illegal lending have periodically prompted actions by reformers. The typical initial response was to enforce usury ceilings more aggressively. But that response often just created more fertile ground for loan sharks to operate. Eventually the failure of efforts to suppress the market became apparent, producing an acceptance of the need to amend the law to allow legal small-dollar lenders to operate.[78]

Historical Efforts to Increase Financial Inclusion

Early efforts at increasing access to consumer credit were through the authorization of "semi-philanthropic lending institutions known as remedial loan societies."[79] These institutions were permitted to charge higher rates than other non-philanthropic lenders but they were still strictly limited in the rates they could charge. But small-dollar loans have substantial risk of loss of repayment and are costly to make in terms of the size of the loan relative to the fixed costs, even for a non-profit organization. Thus, while remedial loan societies were permitted to charge a higher price, it still wasn't high enough—beneficial loan societies fell far short of being able to meet all the demand from small loans serving all the needs of consumers.[80] Moreover, at the still-low permitted interest rates they could charge, they were still limited to lending to relatively lower-risk borrowers, thus did little to reach applicants presenting higher or unknown risks (disproportionately represented by working class, minority, immigrant, and other traditionally underserved households). Credit unions were first authorized in 1909, and Morris Plan banks emerged in 1910.[81] While these institutions also helped to extend needed credit to wage-earners, they played a modest role in meaningfully increasing financial access for many Americans. Credit unions, for example, "were typically organized around workplaces or among workers in a

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[78] Durkin, Et al., *supra* note 25, at 489.

[79] Durkin, Et al., *supra* note 25, at 489.

[80] *See Current Legislation: The Uniform Small Loan Law*, 23 Colum. L. Rev. 484 (1923) ("Philanthropic lending institutions may meet the need of a small number of needy borrowers, but the need for small loans is too great to be adequately met in this way, even if charity be considered an effective cure for an economic evil."); Elisabeth Anderson, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform, 1909-1941*, 37 Theory and Society 271, 291 (2008).

[81] *See* Durkin, Et al., *supra* note 25, at 490; *see also* James R. Barth and Yanfei Sun, *Industrial Banks: Challenging the Traditional Separation of Commerce and Banking*, 77 Q. Rev. Econ. and Fin. 220 (2020).

particular employment sector, [thus] they failed to meet the needs of the poorest borrowers, those who were unemployed or marginally employed."[82]

The first wave of reform was spearheaded by the Russell Sage Foundation in the 1910s and culminated in the Uniform Small Loan Law (USSL), which created a clear regulatory framework for small-dollar loans. The first edition of the USSL was published in 1916 and went through successive drafts through a seventh edition published in 1942.[83] At the heart of the Russell Sage Foundation's reforms was a proposal to increase the permissible interest rate ceiling on small-dollar loans so as to make it feasible to provide credit to wage-earners legally and to still earn a reasonable rate of return on capital. By making legal small-dollar lending economically feasible, the USSL brought small-dollar lending out of the shadows and into the regulated market which, among other benefits, enabled more effective regulation of abusive collection activity.[84] Moreover, once legal, the market also became more transparent and competitive.[85] As noted by Samuelson above, the reforms advanced by the Russell Sage Foundation were resisted by many of the existing illegal lenders, which were prospering under the illegal lending regime.[86] It was estimated that prior to the adoption of small-loan legislation, the interest rate on illegal loans was approximately 10 to 20 percent per month, and annual rates of 500 to 1000 percent or even higher were found.[87] Still, desperate families needed help to deal with life's setbacks and turned to these lenders for lack of any alternative. Moreover, because borrowers needed the money, they were reluctant to complain to authorities and jeopardize a future source of credit.

The illegal lenders' crusade against raising prevailing interest-rate ceilings was indirectly supported by many advocacy groups, religious leaders, and public officials, who persisted in their demands for unrealistically low usury ceilings. One headline portrayed the Russell Sage Foundation as a Wall Street front, "Wall Street Warns Colorado She Must Triple Interest Rate:

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[82] Anderson, *supra* note 80, *see also Current Legislation, supra* note 80, at 484.

[83] *See* George G. Bogert, *The Future of Small Loan Legislation,* 12 Univ. of Chicago L. Rev. 1 (1944).

[84] *See* David H. Rogers, Consumer Banking in new York (1974); Benjamin S. Horack, *A Survey of the General Usury Laws,* Law and contemporary Problems (1941); *Current Legislation, supra* note 80, at 487 ("[U]nder the [USSL] the business of money lending has been brought into the light, has changed from an underhanded, semi-legal enterprise which the world stigmatized as loan shark to that of an honorable, commercial venture, while at the same time the interest charges to the borrowing public have been lowered from the former exorbitant amounts of from one hundred per cent to one thousand per cent to a comparatively small rate of forty-two per cent per annum.").

[85] *See* Bruce G. Carruthers, Timonty W. Guinnane, and Yoonseok Lee, *Bringing "Honest Capital" to Poor Borrowers: The Passage of the U.S. Uniform Small Loan Law, 1907-1930,* 42 J. Interdisciplinary History 393 (2012). For example, even though Morris Plan banks provided needed credit to workers, the Russell Sage Foundation was a critic of those lenders because of their non-transparent pricing. *Id.*

[86] Anderson, *supra* note 80, at 285.

[87] Id.

Rockefeller and Sage Foundations Send Envoy."[88] Still, despite this "Bootleggers and Baptists"[89] coalition of opposition to legalized higher-cost lending, the indefatigable education and activism efforts of the Russell Sage Foundation's Arthur Ham resulted in the gradual adoption of the USSL throughout the country.[90] By 1932, twenty-five states had adopted a version of the USSL, and by the 1960 almost all states had done so. In states where the USSL was adopted, illegal lending largely disappeared.

Some states, however, adopted parts of the USSL, but not the higher interest rate ceilings. Other states adopted the USSL's higher interest rate ceilings but over time reduced permitted charges.[91] In response to the Great Depression, which was seen at the time as having been precipitated in part by excessive use of consumer credit,[92] many states reinstated lower usury ceilings and added a new requirement that before a new small-loan provider should be licensed under the USSL, the applicant would be required to demonstrate that doing so would serve the "convenience and advantage" of the community. This erected a government-enforced barrier to entry and reduced competition.[93] The original foundation of the "convenience and advantage" restriction on entry was the belief crystallized during the New Deal that there were economies of scale in consumer lending and that there were minimum economies of scale necessary to remain financially stable and to engage in responsible lending practices. Excessive competition, it was thought, would result in a market with too many competitors of inefficiently small size that would then compete excessively for business and lend excessively to higher-risk consumers. As a result, small-dollar lenders should be regulated like public utilities to ensure adequate economies of scale and returns on capital (similar requirements are common in areas regulated

88 Anderson, *supra* note 80, at 284 (quoting *The Denver Post*, Feb. 14, 1919). Sage himself had been a financier known for his "ruthless lending practices." His widow took the lead in turning the Russell Sage Foundation into a leader for poverty relief, including promotion of small-loan laws.

89 See Bruce Yandle, Bootleggers and Baptists: The Education of a Regulatory Economist, 7(3) Regulation 12 (May-June 1983).

90 *See* Arthur Ham, The Campaign Against the Loan Shark (192); *see also* Louis N. Robinson and Rolf Nugent, The Regulation of the Small Loan Business (1935); Rolf Nugent, *Three Experiments with Small Loan Interest Rates*, Harv. Bus. Rev. (1933); Rolf Nugent, *The Loan Shark Problem,* Law and Contemporary Problems (1941).

91 *See* F.B. Hubachek, *The Development of Regulatory Small Loan Laws,* 8 L. & Contemporary Problems 108 (1941).

92 See Charles E. Persons, Credit Expansion, 1920 to 1929, and its Lessons, 45 Q. J. Econ. 94 (1930); see also Martha L. Olney, Avoiding Default: The Role of Credit in theConsumption Collapse of 1930, 114 Q. J. Econ. 319 (1999); Barry Eichengreen and Kris Mitchener, The Great Depression as a Credit Boom Gone Wrong, Bak for International Settlements BIS Working Papers No. 137 (Sept. 2003).

93 NCCF Report, *supra* note 2, at 47.

as public utilities, such as hospitals).[94] The NCCF reviewed this claim and found no support for the hypothesis that there are significant economies of scale in small-dollar lending operations, but that those requirements operated as an anti-competitive barrier to entry.[95] The NCCF also rejected the idea that consumers benefited from taking a public utility approach to the regulation of small-loan companies. Instead, it concluded that eliminating regulatory barriers to entry and competition would create incentives to provide credit at market-clearing prices to all consumers: "The profit motive should be strong enough in our economy to assure that credit grantors will try to make as much credit available as possible at 'fair' prices and that if one creditor's 'blind spot' keeps him from extending credit to a creditworthy individual, another creditor will probably jump at the chance."[96] As the NCCF further noted, in a competitive market, there is no basis to judge whether "all have obtained 'all' the credit of the 'type' they wanted, that they were 'entitled' to, at a 'fair' rate." The NCCF continued, "Nor can [the Commission] say that the price of hamburger or shoes was 'fair' at any given time, or that more of either might be better. In almost all instances in our economic system, we 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."[97]

The linchpin of the NCCF's approach to access and inclusion was the promotion of competition and the elimination of usury ceilings and other regulatory barriers that interfered with the natural flow of market forces that it hoped would serve all consumers at competitively set prices. Marginal consumers were those most likely to from elimination of uncompetitive approaches to lending.

The NCCF went so far as to suggest that if the states refused to reform their laws and regulations, federal preemption might be appropriate to protect marginal consumers:

The Commission recommends a consistent approach. If there is to be free access, open competition, and elimination of harmful or inappropriate practices, then *inhibiting* rate ceilings should be reviewed and revised to allow competitive forces to operate.

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94 *See* NCCF, *supra* note 2, at 102; Edwin M. Stockes, *Convenience and Advantage in Small Loan Licensing, A Workable Standard,* 2 Boston College Industrial and Commercial Law Review 93, 94 (1960) (noting that the "convenience and advantage" requirement was added in the fifth draft of the Uniform Small Loan Law in 1932 because "experience had shown" that "the public interest was not well served where competition was too severe").

95 *See* NCCF, *supra* note 2, at 114.

96 NCCF, *supra* note 2, at 2.

97 NCCF, *supra* note 2, at 3.

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 designed 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.[98]

Deregulation of Credit Card Interest Rates: Effects on Financial Inclusion

The NCCF's hypothesis that competition would promote financial inclusion was quickly tested and confirmed within just a few years when the United States Supreme Court decided the monumental case of *Marquette National Bank v. First of Omaha Service Corp.*[99] In a unanimous decision authored by Justice William Brennan, the Supreme Court held that under the National Bank Act, the interest rates that federally chartered banks could legally charge would be established by the regulatory regime of the state in which the bank was located, rather than the state where the transaction in question occurred. This holding was particularly important for credit card issuers, which by that time had started to market their credit card products across state lines.[100]

The case arose from a challenge by Marquette National Bank of Minnesota to the entry of First Omaha Service Corporation, a Nebraska-based institution, into Marquette's traditional territory. Both institutions offered cards under the BankAmericard brand (now known as Visa). As a Minnesota-based bank, Marquette was governed by the state's 12 percent usury ceiling, whereas First of Omaha was subject to Nebraska's higher permitted ceiling of 18 percent on the first $999.99 of unpaid balances and 12 percent on balances above this amount. More significant, however, was that to offset Minnesota's below-market rate ceiling, Marquette charged an annual fee (euphemistically termed a "privilege fee" or "membership fee") of $10, formerly $15.[101] Adjusted for inflation, a $15 annual fee in 1978, the year of the *Marquette* decision, is equivalent to $58.99 today. Because First of Omaha was governed by Nebraska's higher rate ceiling, by contrast, it was able to offer its card without an annual fee for consumers and to charge an interest rate that more accurately reflected relative risk and operating costs. Rising interest rates

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[98] NCCF, *supra* note 2, at 4.

[99] 439 U.S. 299 (1978).

[100] *See* Zywicki, *The Economics of Credit Cards*, *supra* note 32.

[101] Minnesota's statutory scheme permitted charging an annual fee of up to $15. 439 U.S. at 303.

and inflation during the 1970s pushed up credit card interest rates as well, putting increasing pressure on consumers in states with lower interest rate ceilings.

Marquette complained that First of Omaha had an unfair competitive advantage because its no-annual-fee card was more attractive to consumers than the card terms Marquette realistically could offer.[102] Indeed, Marquette's lawyer admitted that one purpose of Minnesota's legal regime was to protect its state's banks from competition, independent of any adverse impact on Minnesota consumers.[103] The Court recognized that any alternative rule, such as applying the law of the state in which a particular transaction occurred, would be unworkable. Although Minnesota consumers would most often use their cards to transact with Minnesota merchants, the BankAmericard system was created to enable consumers "to purchase goods and services from participating merchants and obtain cash advances from participating banks throughout the United States and the world."[104] As the Court noted, "Minnesota residents can thus use their Omaha Bank BankAmericards to purchase services in the state of New York or mail-order goods from the State of Michigan. If the location of the bank were to depend on the whereabouts of each credit-card transaction, the meaning of the term 'located' would be so stretched as to throw into confusion the complex system of modern interstate banking. A national bank could never be certain whether its contacts with residents of foreign States were sufficient to alter its location for purposes of §85 [of the National Bank Act]."[105] As Americans became more mobile and the volume of interstate transactions increased as a result of improvements in communications technology, the costs of a state-by-state regulatory system became increasingly apparent.

As *Marquette* illustrates, once all the unintended consequences are considered, usury regulations had a strongly regressive effect and an adverse effect on financial inclusion. First, by establishing such a low permissible rate of finance charge, the presence of binding usury ceilings

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[102] 439 U.S. at 304 ("Marquette claimed to be losing customers to Omaha Bank because, unlike the Nebraska bank, Marquette was forced by the low rate of interest permissible under Minnesota law to charge a $10 annual fee for the use of its credit cards." The record suggests that Marquette's card program was acquired from an earlier institution that charged a $15 annual fee.)..) In response to this argument First of Omaha's lawyer Robert Bork rejoined that if that was the problem, Marquette "would have done better to take their case to an advertising agency instead of a law firm." 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 34.

[103] *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 25 (argument of John Troyer on behalf of Marquette National Bank) ("If you're going to allow a Nebraska bank to come in here to the state of Minnesota and by offering the card free draw off, and in effect, to ruin Marquette's bank card program, what's to stop it from going to some other state and doing the same thing? No local, national, or state bank will be safe from the predatory practices, then, of out of state national banks located in the state permitting the higher interest rate.")

[104] 439 U.S. at 312 (quoting Stipulation of Facts, App. 91a).

[105] 439 U.S. at 312.

ensured that only the very lowest risk consumers would gain access to credit cards, whereas credit cards could be made available to many more consumers at higher rates. Second, even when consumers were fortunate enough to gain access to a credit card, credit lines were highly limited. For example, during the 1970s, Arkansas law capped the permissible interest rate on the typical credit card issued by a state institution at 8 percent, far below the otherwise prevailing market rate. As a result, only 10 percent of credit card applications were approved, and the available credit line was often limited to only $800.[106] In fact, as underlying interest rates rose in the economy during the 1970s prior to the *Marquette* decision, the number of credit cards in circulation actually *fell* as interest rates increasing collided with usury ceilings. Lower-income consumers, of course, were those most likely to be rationed out of access to credit cards during this time.[107] Consumers in Minnesota who were unable to gain adequate access to credit cards were forced to substitute to alternative types of credit.[108]

The Supreme Court's decision in *Marquette* held the maximum interest rate that could be charged on credit cards would be the home state of the issuing bank. In that particular case, the winner was Nebraska. But it soon became evident that the big winners over the coming decades would be South Dakota and Delaware, states with no effective interest rate ceilings on credit cards. As was the case in the competition between Marquette and First of Omaha for credit card business, banks headquartered in low-ceiling states such as Arkansas could offer lower interest rates—but with high annual fees and other disliked terms. Indeed, even issuers based in South Dakota could offer a card with a lower interest rate and high annual fee if they wanted to—but the reality was that Marquette complained that First of Omaha was "draw[ing] off" its customers, not the other way around. This preference for a no-annual-fee card is not surprising, especially for lower-income consumers or those who do not revolve balances, which amounts to roughly half of cardholding households.[109] Thus, it is not surprising that in the wake of *Marquette*, no-annual-fee cards quickly came to dominate the market and today are the market standard, except for cards that provide extensive rewards programs such as cards linked to airline frequent flyer rewards.

The effect of *Marquette* for consumers was profound, especially for lower-income and higher-risk borrowers. First, by removing price controls that had prevented many consumers from

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[106] *See* David S. Evans and Richard J. Schmalensee, The Economics of the Payment Card Industry 59 (1993).

[107] *See* Zywicki, *Economics of Credit Cards, supra* note 32, at 162; *see also* Daniel J. Villegas, *The Impact of Usury Ceilings on Consumer Credit*, 56 S. Econ. J. 126, 140 (1989); Glenn B. Canner and James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 Fed. Res. Bull. 1 (1987).

[108] The state's small loan law permitted "33 [percent] for up to $300, 18 percent for $300 to $600, and 15 percent up to $1,200 was the outside limit." 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 14.

[109] *See* Zywicki, *Economics of Credit Cards, supra* note 32, at 117-18.

acquiring cards, it enabled more accurate risk-based pricing of credit offers that could include riskier borrowers in the system. Second, by indirectly eliminating annual fees (which had largely served to circumvent usury ceilings), lower-income consumers could more easily afford to have a card. Indeed, today many consumers hold multiple cards at any given time, effectively increasing their available credit limits (by stacking the credit lines) and fueling competition among card issuers for customer loyalty.[110] Third, deregulation eliminated state usury ceilings that arguably had created price "focal points" that could facilitate implicit collusion among competitors in local markets. Combined with barriers to entry in local banking markets focal-point pricing also tended to dampen competitive forces.[111] *Marquette* spurred entry and competition in previously-protected markets, enabling greater product variety in card features and better matching of products with consumer preferences, including the introduction of cards co-branded with various retail companies and airlines, cash back rewards, or cards co-branded with various non-profit organizations or charities.

Figure 10-1 illustrates the dramatic transformation of the American consumer economy in the aftermath of *Marquette*. In 1970, only 16 percent of American households had a bank-type credit card compared to 45 percent that had a retail store card.[112] By 2001, holders of bank-type cards had risen to 73 percent of households. Among households in the lowest income quintile, the number increased from a mere 2 percent of households in 1970 to 38 percent by 2001. Among the second-lowest quintile households the trend was similar: just 9 percent of those households had a bank-type credit card in 1970 but 65 percent did by 2001.[113]

FIGURE 10-1: FIGURE 10-1: PREVALENCE OF BANK TYPE CREDIT CARDS AND OUTSTANDING BALANCE AMOUNTS, BY HOUSEHOLD INCOME QUINTILES, SELECTED YEARS, 1970-2010, IN PERCENT[114]

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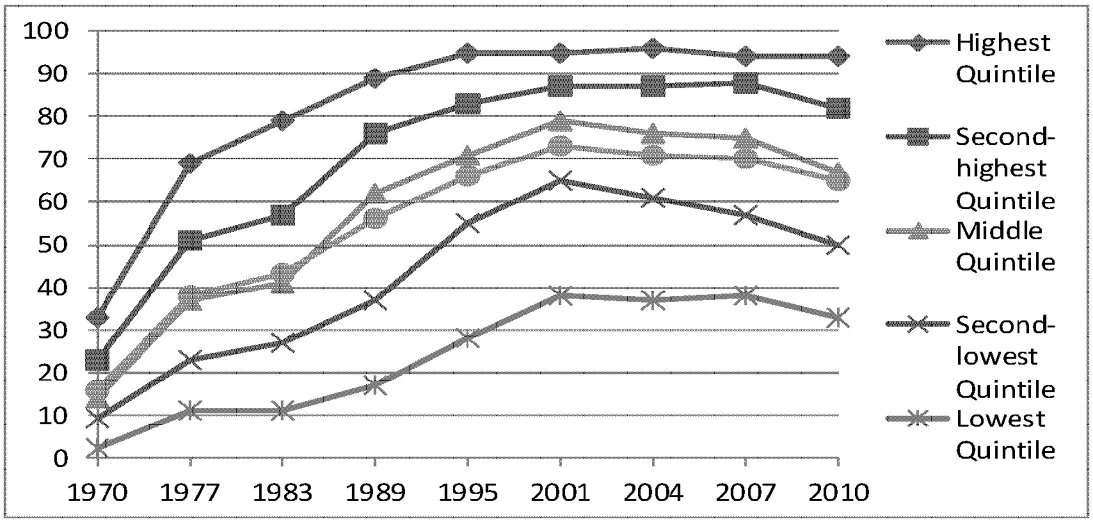
110 The average American holds approximately three to four credit cards today. *See* Matt Tatham, *A Look at U.S. Consumer Credit Debt*, Experian.com (Nov. 4, 2019), *available in* https://www.experian.com/blogs/ask-experian/state-of-credit-cards/. The average number of credit cards held by households dipped following the Great Recession and enactment of the Credit CARD Act of 2009 and as of 2016 still had not recovered. *See* Joe Resendiz, *Average Number of Credit Cards Per Person: 2019 Card Ownership Statistics*, ValuePenguin.com (June 13, 2020), *available in* https://www.valuepenguin.com/average-number-credit-cards-per-person.

111 See Christopher R. Knittel and Victor Stango, Price Ceilings as Focal Points for Tacit Collusion: Evidence form Credit Cards, 93 Am. Econ. Rev. 1703 (2003).

112 "Bank-type card" refers to a general purpose credit card that is generally accepted at most merchants, such as a card issued by a bank under the Visa or MasterCard logo, or a similar card issued by American Express or Discover, which also issue general purpose credit cards but do not partner with a bank to do so.

113 For an extended discussion of the widening and deepening of credit card usage over time, *see* Durkin, Et al., *supra* note 25, at Chapter 7, where these data are compiled.

114 Source: Surveys of Consumer Finances. In 1970, respondents were asked about *using* cards; in all other years, they were asked about *having* cards. Proportions that "have a card" are percentages of all households; proportions



As discussed in Chapter 2, this dramatic growth in credit card holding has not resulted in any observable increase in household debt burdens over this period of time; in fact, the household debt-service ratio today is lower than in 1980.[115] This surprising result—that the rapid spread of credit card access throughout the population has not increased overall household debt burdens—reflects how this growth in credit card usage has been a substitution from other traditional, less-preferred, and more-expensive types of credit such as personal finance companies and retail store credit.[116] In comparison to those alternatives, bank-type credit cards were less expensive (especially after competitive pressures eliminated annual fees), more flexible in usage, offered more flexible repayment terms than traditional installment loans, and offered greater competition for the customer's patronage than products that were tied to one store or location.

As sophistication about risk underwriting grew, credit card issuers began competing more aggressively for consumers, especially more marginal consumers. During the years 1989 to 1995, credit card holding by households increased by 10 percentage points from 56 to 66 percent. New York Federal Reserve Bank economists Sandra E. Black and Donald P. Morgan found that cardholders in 1995 "were more apt to single, more likely to rent, and had less job security than

"carrying a balance" are percentages of holders of bank type cards with an outstanding balance after the most recent payment. Mean and median balances are for cardholders with outstanding balances after the most recent payment and are in 2004 dollars, adjusted using the Consumer Price Index for All Urban Consumers, all items. Shares may not sum to 100 percent because of rounding.

[115] *See* discussion in Chapter 2; *see also* Durkin, Et al., *supra* note 25, at 39-41.

[116] *See* Zywicki, *Economics of Credit Cards*, *supra* note 32.

cardholders in 1989."[117] There also was an increased share of younger households. The medial annual income of cardholders fell $4,700 between 1989 and 1995, and the share of cardholders that were middle or upper class (annual income over $25,000 in 1995 dollars) fell from 78 percent to 72 percent while the share of lower income cardholders rose from 22 percent to 28 percent.[118] As Black and Morgan concluded, "Credit cards are no longer a privilege of white-collar workers" but were increasingly accessible to lower-skilled blue-collar workers.[119]

Recent studies have confirmed the finding that increased competition in consumer finance markets increases financial inclusion. For example, deregulation of interstate bank branching in the United States led to a dramatic increase in access of low-income households to bank accounts, a significant reduction in the rate of unbanked households among low-income populations, an increase in wealth-building for low-income households, and an increase in the number of branches in lower-income areas.[120] The positive effect of increased financial access was largest for the lowest-income households below the poverty line and residents of rural areas.

10.3.3 Credit Reporting, Credit Scoring, and Financial Inclusion

Perhaps the most important contributing factor to greater financial inclusion in recent decades was the development of a comprehensive national credit reporting system and accompanying statistical credit scoring.[121] The creation and evolution of the comprehensive, largely-voluntary credit reporting system has blessed consumers with the "miracle of instant credit," in which any American literally can walk into a car dealership and drive home a brand new car just hours later.[122]

Until the development of statistical credit-scoring systems in the mid-1960s, consumer lending decisions were made individually by thousands of loan officers who exercised their individual

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117 Sandra E. Black and Donald P. Morgan, *Meet the New Borrowers*, 5(3) Federal Reserve Bank of New York Current Issues in Economics and Finance 1 (Feb. 1999).

118 Id.

119 *Id.* at 3.

120 *See* Claire Celerier & Adrien Matray, *Bank Branch Supply and the Unbanked Phenomenon* (Oct. 17, 2016), *available in* https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202016/Unbanked_October2016.pdf.

121 *See* Durkin, Et al., *supra* note 25, at 216-229.

122 *See* Timothy J. Muris, *Protecting Consumers' Privacy: Goals and Accomplishments* (June 22, 2002) (remarks provided at The Network Economy Summit, Reston, VA), *available in* https://www.ftc.gov/public-statements/2002/06/protecting-consumers-privacy-goals-and-accomplishments.

judgment on each application. Their assessment generally relied on a combination of subjective and objective measures of risk. Creditors referred to the "five Cs of lending: character, capacity, capital, collateral, and conditions."[123] Each financial institution developed its own policies to guide these day-to-day lending decisions. But as lending volume increased in the post-War era, it became increasingly difficult for banks, finance companies, and retailers to maintain consistent application of those policies among a growing number of lending officers. As credit operations of department stores and lending companies increasingly became regional and national in scope, one operator might have thousands of loan officers spread across hundreds of stores in dozens of states.[124] This highly individualized and somewhat subjective system of making credit assessments also raised concerns that discretion could be exercised in a discriminatory fashion against members of some demographic groups.

The growth in lending scale produced a growing need by lenders for a less-expensive, less-subjective, and more consistent process for making credit determinations. In time, lenders started to rely on statistical evaluation of creditworthiness based upon this approach. Important developments included the founding of a new company in 1956 by engineer William Fair and mathematician Earl Isaac to implement and sell the Fair Isaac credit scoring system ("FICO").[125] As early as the 1960s, studies of the effectiveness of even early statistical credit scoring models showed they could make more accurate decisions at lower cost than traditional judgment-based models. This could allow lenders to expand their operations to a growing number of consumers at lower cost while suffering minimal increased losses. Over time, individual lenders developed their own proprietary scoring models, followed by generic, standardized credit scoring models using data from credit reporting agencies (CRAs, popularly known as "credit bureaus"). Reliance on scoring models soon became widespread in credit-granting decisions.

The growing use and sophistication of credit scoring enabled the explosion of credit card access after the Supreme Court's *Marquette* decision. Over time, the growing sophistication and use of credit scoring models enabled the birth and growth of risk-based pricing models for lending decisions, allowing greater tailoring of product terms to a consumer's predicted level of risk. The evolution of risk-based pricing, in turn, led to an expansion of credit to higher-risk borrowers and lower prices for lower-risk borrowers, without increasing loss rates.[126] As discussed in Chapter 9 as well as below, creditors and CRAs have continued to innovate in their credit

[123] *See* Durkin, Et al., *supra* note 25, at 216-217.

[124] *Id.* at 217.

[125] *Id.* at 220.

[126] *Id.* at 227; *see also See* Board of Governors of the Federal Reserve System, Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit (Aug. 2007); Wendy Edelberg, *Risk-Based Pricing of Interest Rates for Consumer Loans*, 53 J. of Monetary Econ. 2283 (2006).

scoring models to make increased use of new and valuable alternative data that traditionally have not been included in credit scores, such as payments on recurring financial obligations, such as utilities and rent, as well as cash-flow data.

Credit reporting and credit scoring models also facilitated market entry and competition.[127] A consumer's current financial provider possesses a large amount of private information based on its experience with that consumer, which provides it with an information advantage over potential competitors. This advantage also creates an adverse selection problem for other potential providers because it implies those consumers who are seeking credit have already been rejected for credit by the potential provider with the greatest knowledge of their circumstances. Credit reporting and credit scoring systems reduce the information asymmetry between lenders and borrowers (as described in Chapter 11) but also between an individual's current provider and potential alternative suppliers. The rapid entry of new firms into the credit card market following the Supreme Court's decision in the *Marquette* case illustrates the value of credit scoring systems in promoting competition.

Statistical credit scoring systems have also been particularly important in addressing concerns about discrimination in lending. By substituting statistical underwriting models for the individualized assessments of thousands of loan officers, credit scoring systems made credit-granting processes more transparent and consistent than previously, thereby reducing concerns about discrimination based on race and other illegal factors in credit-granting decisions. Of course, credit-granting models can still use facially neutral factors, such as ZIP code, that can raise concerns under a disparate impact theory, especially if the creditor lacks a business justification for the factor's use. Congress required the Federal Reserve Board to research whether credit scoring models that produced scores sold by credit reporting agencies (such as FICO and Vantage) have a disparate impact on protected groups. Its report determined that these credit scoring models are generally accurate across different demographic groups and do not result in illegal discrimination.[128]

[127] Durkin, Et al., *supra* note 25, at 268-69.

[128] *See* Federal Reserve Board, Report to Congress, *supra* note 126; Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Does Credit Scoring Produce a Disparate Impact?*, 40 Real Estate Econ. 965 (2012) (finding no disparate impact from use of credit scores on mortgage credit underwriting or pricing for race or gender but finding evidence of some disparate impact by age that lowers the credit score of older individuals relative to younger).

10.4 Consumer Demand for Financial Inclusion: Profile of Excluded Consumers

Financial inclusion can be understood as having two basic components: access to a basic transaction or bank account and access to credit products such as credit cards. We first examine the profile of unbanked consumers to understand why they do not have a bank account and how public policy might be able to help those who want bank accounts to achieve them. Then we look at a particular challenge in terms of access to credit, the problem of "credit visibility" that can prevent those who are creditworthy from accessing credit.

10.4.1 Who Are the Unbanked and Why are They Unbanked?

According to the Federal Deposit Insurance Corporation (FDIC), in 2019 an estimated 5.4 percent of U.S. households were classified as "unbanked," meaning that no one in the household had a checking or savings account at a bank or credit union.[129] This represents about 7.1 million U.S. households. The Federal Reserve estimates that about 6 percent of American adults did not have a checking, savings, or money market account in 2019.[130] In addition, the Federal Reserved considered 16 percent of adults to be "underbanked," meaning they had a bank account but also used an alternative financial service product such as a money order, check cashing service, or similar product. Half of unbanked adults used some form of alternative financial service.[131] Unbanked rates are higher than average for lower-income and less-educated households,

[129] Federal Deposit Insurance Corporation, How America Banks: Household Use of Banking and Financial Services, 2019 FDIC Survey 1 (2020) (hereinafter 2019 FDIC Survey). This is a decline of 1.1 percentage points over 2017. About half of the decline in the unbanked rate was the result of improvements in socioeconomic circumstances of U.S. households over that period. *Id.* We leave aside discussion of those consumers who choose not to use mainstream financial products for non-benign purposes such as tax evasion, avoidance of legal judgments and garnishments, or to facilitate criminal activities. In the biannual FDIC surveys of unbanked and underbanked households, one of the top-five answers has typically been some variation of "avoiding a bank gives more privacy." This is obviously a legitimate reason for many consumers to avoid using a bank but it might be an indirect (and imperfect) measure of a desire to avoid scrutiny of one's financial activities. For example, in the 2019 version of the survey, that answer was the third-most common answer, with 36 percent of respondents identifying it as one reason for not having a bank account and 7 percent identifying it as the "main" reason. *Id.* at 17, Fig. 3.5 (2020).

[130] Board of Governors of the Federal Reserve System, Report on the Economic Well-Being of U.s. Households in 2019, Featuring Supplemental Data from April 2020, at p. 27 (May 2020).

[131] Id.

minority households (Black or African American, Hispanic, and American Indian or Alaska Native), working-age disabled households, and households with more volatile income.[132]

A central element of the FDIC survey is to ask unbanked consumers why they do not have a bank account.[133] Over the last several FDIC surveys, the primary reason offered by unbanked households for not having a bank account is some variation on the response that they "Don't Have Enough Money to Meet Minimum Balance Requirements" or they "Do not have enough money to keep in account." In 2019, 48.9 percent stated the inability to meet the minimum balance requirement as a reason for not having a bank account, and 29 percent cited it as the "main" reason for not having an account, almost double that of the second most common reason ("Don't Trust Banks"). The related answer, "Bank Account Fees Are Too High," was cited by 34.2 percent of unbanked consumers as a reason for not having a bank account, with 7.3 percent citing that as the "main" reason.[134] Respondents to the 2017 Survey provided a similar ranking of reasons for not having a bank account.[135]

Although the pattern of these answers has been generally consistent over the last several surveys, this has not always been the case.[136] The 2011 and 2009 surveys asked different questions, and unbanked consumers answered them in different ways, so they are difficult to

[132] 2019 FDIC Survey, *supra* note 129, at 1.

[133] We leave aside discussion of those consumers who choose not to use mainstream financial products for non-benign purposes such as tax evasion, avoidance of legal judgments and garnishments, or to facilitate criminal activities. In the biannual FDIC surveys of unbanked and underbanked households, one of the top-five answers has typically been some variation of "avoiding a bank gives more privacy," which might be an indirect (and imperfect) measure of a desire to avoid scrutiny of one's financial activities. For example, in the 2019 version of the survey, that answer was the third-most common answer, with 36 percent of respondents identifying it as one reason for not having a bank account and 7 percent identifying it as the "main" reason. 2019 FDIC Survey, *supra* note 129, at 17, Fig. 3.5 (2020)

[134] 2019 FDIC Survey, *supra* note 129.

[135] Federal Deposit Insurance Corporation, 2017 FDIC National Survey of Unbanked and Underbanked Households 4, Fig. ES.4 (Oct. 2018) (52% cited not having enough money to maintain a bank account and 34% said it was the "main" reason, "account fees too high" was identified as the third most common "main" reason)

[136] This ordered ranking of the "Main" reason for not having a bank account has been consistent for several years. In the 2015 Survey, for example, 37.8% cited "Do not have enough money to keep in account," 10.9% said "Don't trust banks," and nearly as many (9.4%) said "Account fees too high" and another 1.9% said "Account fees unpredictable." In that survey, 5.3% cited "Inconvenient locations" and "Inconvenient hours" combined as the main reason for not having a bank account. Federal Deposit Insurance Corporation, 2015 FDIC National Survey of Unbanked and Underbanked Households 3, Fig. ES.2 (Oct. 20, 2016). The 2013 survey again found similar figures. Notably, after "Do not have enough money" (which 35.6% cited as the main reason), 14.9% said "Don't like dealing with or don't trust banks," and 13.4% listed as the main reason "Account fees are too high or unpredictable." Federal Deposit Insurance Corporation, 2013 FDIC National Survey of Unbanked and Underbanked Households 7, Fig. ES.3 (Oct. 2014).

compare to the more recent surveys.[137] Nevertheless, in the 2011 survey only 4.0 percent of never-banked households reported that the reason they did not have a bank account was because "Bank account fees or minimum balance requirements are too high," a figure that had more than tripled by 2013 to 13.4 percent in answers to an analogous question. This figure has remained about 10 percent in every survey since that time. Similarly, in 2009 only 6.3 percent of unbanked consumers said that "Service charges are too high" was the reason why they did not have a bank account compared to 34 percent in the most recent survey. A decade ago, the cost of maintaining a bank account and high fees did not present a major obstacle to obtaining a bank account but has become an increasingly larger obstacle since then.

Beyond the high cost of a bank account, the second reason why many consumers choose not to have a bank account is because they do not trust banks. In the 2019 survey, "Don't Trust Banks" was cited by 36 percent of unbanked consumers as a reason and 16 percent as the "Main" reason.[138] It is not clear what exactly unbanked consumers mean when they provide this answer, as it covers a broad swath of possible responses. Comparison of recent surveys to earlier editions of the FDIC survey suggests that this relatively generic answer captures a constellation of factors beyond a literal distrust of banks. For example, the FDIC's 2009 survey provided 17 prompted possible responses at a more disaggregated level of specificity than the more recent versions, which only offer 9 prompted responses. The 2009 edition of the survey included possible answers like "Banks do not feel comfortable or welcoming" (offered by 9.1 percent of respondents) and "There are language barriers at banks" (offered by 6.9 percent) in addition to the response "Do not trust banks" (6.3 percent).[139] It therefore seems probable that many of those more recently classified under the general category "Don't Trust Banks" might also include those who previously stated that they did not "feel welcome" or faced language barriers. If so, this suggests that many unbanked consumers might consider opening a bank account if this "trust" hurdle could be overcome, for example by banks' becoming more welcome to non-traditional customers or improving services for non-English speakers.[140] Unbanked consumers might also distrust banks because they feel like banks present many traps for the unwary—bank

[137] *See* Federal Deposit Insurance Corporation, 2011 FDIC National Survey of Unbanked and Underbanked Households 27, Fig. 5.9 (Sept. 2012); Federal Deposit Insurance Corporation, 2009 FDIC National Survey of Unbanked and Underbanked Households 25, Fig. 4.12 (Dec. 2009).

[138] In the 2017 Survey "Don't Trust Banks" was also the second most common response as both a cited reason (30.2%) and main reason (12.6%) for not having an account. *See* 2017 FDIC Survey, *supra* note 135.

[139] *See* 2009 FDIC Survey, *supra* note 137, at 25, Fig. 4.12.

[140] This feeling of trust, feeling welcome, or feeling valued as a customer is a common explanation given by many consumers for why they use alternative financial providers such as payday loans instead of mainstream providers. *See* Lisa Servon, The Unbanking of America: How the New Middle Class Survives (2018).

accounts are complicated and can be difficult to manage, especially by those with limited funds or financial sophistication.[141]

Another problem with bank accounts for some consumers is the delay that can be involved in accessing one's funds while waiting for payments to clear and post. As a result, even those with a bank account can be forced to use check cashers and other alternative financial service providers in order to gain speedy and convenient access to their funds. The FDIC's 2019 survey, for example, found that 17 percent of households that have a bank account have also used some form of money transaction service such as a money order, check casher, or bill payment service, almost always to pay a bill.[142] Prior versions of the survey indicate that a primary reason why some households still use these alternative transaction services despite having a bank account is gain access to their money in order to pay bills on time.[143] Banks inexplicably can still take three days or longer to grant customers access to their deposits.[144] Fedwire and the National Settlement Service, two wholesale payment services used to settle payments flows electronically, are closed on weekends, thus consumers who need access to their money over the weekend can face particularly long delays.[145] Dealing with these delays in payment processing can be especially difficult for low-income consumers who live paycheck-to-paycheck and are unable to maintain substantial buffers in their bank accounts to cover flows of funds in and out of the account.[146] The Taskforce has located no sound evidence as to how much usage of expensive alternative financial services could be reduced by a faster payments system.[147] Further research on this point is warranted.

Another general category of reasons why consumers say they are unbanked covers "Personal, Identification, Credit or Former Bank Account Problems." Although this problem is not

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141 Alternative financial providers, by contrast, generally offer very simple and transparent terms with few surprises and "hidden" fees. Even if fees for these products are higher (and in many instances they are not), consumers may feel like those fees are at least comprehensible, transparent, and predictable. *Id.*

142 *See* 2019 FDIC Survey, *supra* note 129, at 35.

143 *See* 2011 FDIC Survey, *supra* note 137, at 37. Many respondents also said that banks charged more to acquire these services than non-bank alternative financial providers.

144 *See* George Selgin and Aaron Klein, *We Shouldn't Have to Wait for FedNow to Have Faster Payments*, Am. Banker (Feb. 28, 2020).

145 Id.

146 *See* Federal Reserve Board Governor Lael Brainard, *Delivering Faster Payments for All* (Aug. 5, 2019), *available in* https://www.federalreserve.gov/newsevents/speech/brainard20190805a.htm.

147 *See* Aaron Klein, *The Fastest Way to Address Income Inequality? Implement a Real time Payment System*, www.Brookings.edu (Jan. 2, 2019), *available in* https://www.brookings.edu/research/the-fastest-way-to-address-income-inequality-implement-a-real-time-payment-system/; Aaron Klein, *Real-Time Payments Can Help Combat Inequality*, www.Brookings.edu (Mar. 6, 2019), *available in* https://www.brookings.edu/opinions/real-time-payments-can-help-combat-inequality/.

widespread, it is an overwhelming obstacle for those impacted by it. For example, in the 2019 FDIC survey, answers to this effect ranked only sixth of ten prompted answers as being a reason for not having a bank account, but this response ranked *third* as the "main" reason for not having an account.[148] In some cases, this obstacle arises from problems with managing a bank account earlier in life that resulted in having one's bank account involuntarily closed. In some instances, personal identification issues can arise from one's immigration status.[149]

Some individuals who lack sufficient identification or credit history may also be those who, after serving lengthy prison sentences might lack a recent credit history or were victims of identity theft while in prison.[150] These individuals are much more likely to use alternative financial products than the general population, with the largest disparities in product use exhibited with products that are most heavily used by unbanked populations, such as check cashers and pawn shops.[151] Because of demographic differences in incarceration rates among races, the difficulty of formerly incarcerated individuals in accessing the banking system upon release also reinforces racial disparities in access to financial products.[152] The Taskforce urges the CFPB, Department of Housing and Urban Development (HUD), and other relevant bodies to examine the difficulties confronted by formerly incarcerated individuals in establishing access to financial products upon release and to consider efforts to alleviate barriers where possible.

This lack of personal identification and similar paperwork barriers might also be a by-product of the application of anti-money laundering and bank secrecy act laws that raise the economic costs and regulatory and identification barriers to banks providing financial services to non-traditional customers.[153] Anti-money laundering laws have also been identified as a potential

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148 2019 FDIC Survey, *supra* note 129.

149 16.2 percent of foreign-born non-citizen households lack a bank account, compared with 5.9 percent of U.S.-born and 4.8 percent of foreign-born citizen households. *See* Federal Deposit Insurance Corporation, 2017 FDIC National Survey of Unbanked and Underbanked Households: Appendix Tables, *supra* note 135, at 6, Table A.3 *See also* Diego Zuluaga, *Going Postal? Proposals for Post-Office Banking in 2020*, www.Alt-M.org (Oct. 16, 2020), *available in* https://www.alt-m.org/2020/10/16/going-postal-proposals-for-post-office-banking-in-2020/. Although legal immigrants do not necessarily have identification or documentation issues they do face challenges because of a lack of reportable credit and financial history.

150 *See* David Benoit, *Ex-Inmates Struggle in Banking System*, Wall St. J. at p. B9 (Nov. 2, 2020).

151 See Marc D. Glidden and Timothy C. Brown, Separated by Bars or Dollar Signs? A Comparative Examination of the Financial Literacy of Those Incarcerated and the General Population, 42 Am. J. Crim. Justice 533 (2017); see also Marc D. Glidden, Timothy C. Brown, Molly Smith, and Mary H. Hughes, Prisoners with Purses: The Financial Literacy and Habits of Incarcerated Women, 5 Corrections: Policy, Practice, and Research 377 (2018).

152 *See* Benoit, *supra* note 150.

153 *See* Daniel J. Mitchell, *Money Laundering Laws: Ineffective and Expensive*, Cato At Liberty (Oct. 22, 2016), *available in* https://www.cato.org/blog/money-laundering-laws-ineffective-expensive; Daniel J. Mitchell, *World Bank: Anti-Money Laundering Rules Hurt the Poor*, Cato At Liberty (Apr. 20, 2012), *available in* https://www.cato.org/blog/world-bank-anti-money-laundering-rules-hurt-poor.

barrier to FinTech development,[154] despite how greater use of FinTech to facilitate cross-border transactions could simultaneously increase both financial inclusion and anti-money laundering compliance.[155] As part of its research, outreach, and dialogue with governmental and non-governmental stakeholders, the Taskforce has tried to determine the extent to which compliance with anti-money laundering laws and risk-management imposes an undue burden on financial inclusion but it has not been able to make that determination. The Taskforce recognizes, of course, that these laws play a legitimate and important purpose in preventing terrorism and the facilitation of criminal activity. But the Taskforce also notes the concern that many have expressed for ensuring that the application of these laws does not unduly interfere with the goal of financial inclusion. As observed by a World Bank study several years ago, "[T]he Financial Action Task Force, recognizing that overly cautious Anti-Money Laundering and Terrorist Financing (AML/CFT) safeguards can have the unintended consequence of excluding legitimate businesses and consumers from the financial system, has emphasized the need to ensure that such safeguards also support financial inclusion."[156] The view of the Taskforce is that this issue warrants more focus and research across the government to ensure that anti-money laundering and terrorist financing laws are well-tailored to accomplish their goals with minimal adverse impact on innocent consumers.

10.4.2 Credit Invisibles"

As discussed above, the development of the comprehensive national credit reporting system has been one of the major catalysts for growing financial inclusion in the American consumer financial sector. Yet many Americans remain outside the traditional credit reporting system and as a result are unable to gain access to many mainstream financial products on beneficial terms.[157]

There are two groups of consumers that are not fully "visible" to the consumer finance system.[158] The first are those who lack credit records with the three nationwide credit reporting agencies, which the CFPB calls specifically "credit invisible." The CFPB refers to the second group of

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[154] *See* David R. Burton and Norbert J. Michel, *Financial Privacy in a Free Society,* Heritage Foundation Backgrounder 14-15 (Sept. 23, 2016).

[155] *See* Michael Barr, Karen Gifford, and Aaron Klein, Enhancing Anti-Money Laundering and Financial Access: Can New Technology Achieve Both?, The Brookings Institution (Apr. 2018).

[156] Asli Demirgue-Kunt and Leora Klapper, Measuring Financial Inclusion: The Global Findex Database 20, World Bank Policy Research Working Paper 6025 (Apr. 2012).

[157] *See* Consumer Financial Protection Bureau, Data Point: Credit Invisibles (May 2015).

[158] *Id.* at 4.

consumers as "unscorable," meaning "they contain insufficient credit histories to generate a credit score.[159]

Examining data collected in 2010, the CFPB estimated that 26 million consumers were credit invisible, representing approximately 11 percent of the adult population. An additional 19 million consumers, or 8.3 percent of the adult population, were considered unscorable.[160] Residents of low-income neighborhoods, Blacks, and Hispanics, were all more likely to be credit invisible or unscorable than residents of high-income neighborhoods, Whites, or Asians. Age, however, was also a significant predictor of the likelihood of being credit invisible or unscorable, which suggested "that those differences materialize early in the adult lives of those consumers and persist after."[161] This further suggests that interventions designed to increase the likelihood of having a scored credit record would be most effective early in adulthood.

10.5 Fair Lending and Discrimination

In addition to facially neutral laws and regulations, such as usury ceilings that have impacted financial access for all, some Americans have also faced direct or indirect discriminatory barriers based on their race, sex, immigrant status, or other personal demographic characteristics. American history provides ample examples of mistreatment by government officials, banks, retailers, and others based on animus and unjustified stereotypes about groups of people. Public concern about equal access to credit animated the landmark Fair Housing Act of 1968 ("Fair Housing Act") and the Equal Credit Opportunity legislation of 1974 (ECOA) and subsequent amendments that prohibited discrimination in the provision of financial services on the basis of the enumerated characteristics.

This section briefly reviews the history of discrimination in lending practices in the United States that culminated in the enactment of the Fair Housing Equal Credit Opportunity Act and (ECOA). It then turns to a review of legal and other regulatory barriers that presented barriers to financial inclusion of minority groups, including usury ceilings and expressly discriminatory laws that facilitated discrimination in housing markets.

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[159] The CFPB identifies two basic reasons why a credit record might be considered unscorable, either because it contains "insufficient information to generate a score" (such as too few accounts or those accounts are too new) or the account has become "stale" because "it contains no recently reported activity." *Id.* at 4.

[160] *Id.* at 6; *see also* Alyssa Stewart Lee, Ann Schnare, Michael A. Turner, Patrick D. Walker, and Robin Varghese, *Give Credit Where Credit is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data* (Brookings Institution, 2006) (estimating 35 million to 54 million consumers in 2006 with limited or no credit files).

[161] Credit Invisibles, *supra* note 157, at 6.

The role of discrimination in consumer lending markets has a long and painful history, especially with respect to racial minorities. America's history of societal and political racial injustice is well-known and has shaped virtually every element of American society, including financial inclusion. This legacy of injustice is particularly so with respect to racial discrimination in mortgage finance markets, where New Deal-era government policies designed to maintain racial segregation through "redlining" and other policies that continue to exert long-term effects even today even though they were officially eliminated decades ago. Although not the only cause of continued racial inequality in income and wealth, decades of discriminatory government policies have had effects that are still being felt today. Societal and economic discrimination against other groups on the basis of sex, marital status, immigrant-status, and age, have also been an unfortunate part of America's history.

The enactment of the Fair Housing Act and ECOA outlawed discriminatory treatment based on many of these impermissible considerations. As discussed below, the Taskforce believes that Congress should consider revisiting equal credit opportunity laws to consider expanding their coverage in light of changes in societal norms, such as to prohibit discrimination in credit granting on the basis of disability.

In addition to underlying problems of discrimination and lack of economic opportunity, there also were regulatory barriers to inclusion and competition aside from government-imposed discrimination in mortgage markets that exacerbated the effects of those underlying challenges. While policies designed to promote inclusion and competition are no panacea for deeper societal and economic challenges, erecting barriers to credit can exacerbate those challenges and inadvertently facilitate private discriminatory behavior.

10.5.1 The Effect of Historic Discriminatory Government Housing Policies

Societal and political discrimination and unequal treatment of many Americans based on race, sex, immigrant status, and other features have been long-standing injustices. Over time these injustices also influenced and shaped government policy and market institutions with respect to consumer finance, inclusion, and consumer protection.

The roots of unequal treatment based on individual characteristics go back centuries. Discrimination based on race has been particularly egregious and overt. These practices were rife in the Reconstruction era. Of particular modern relevance was the development of government housing finance policy beginning during the New Deal and extending into the post-

War era, which shaped the residential patterns of the emerging suburbs.[162] Vestiges of these discriminatory policies persist today in continued segregated residential living patterns, lower wealth holdings among different demographic groups and residential patterns, and broader effects on economic opportunity.

Most well-known of the federal government's discriminatory policies was the notorious practice of "redlining" imposed by the Home Owners Loan Corporation (HOLC) during the New Deal.[163] The HOLC was established in 1933 to deal with the problem of rising home foreclosures during the Great Depression.[164] The term "redlining" arose from HOLC's practice of creating color-coded maps that indicated the relative desirability of different neighborhoods from the perspective of appraisals. Often these evaluations were based on the race of the residents rather than some other criterion such as income. For example, neighborhoods colored green were considered the most desirable rising neighborhoods, meaning "new, homogenous, and in demand as residential locations in good times and bad," consisting predominantly of "American business and professional men." Down through the tiers went the classification through blue-colored (stable neighborhoods) and yellow-colored neighborhoods ("definitely declining"), until the fourth category—colored red—was reached. Neighborhoods colored red were considered those "in which the things taking place in [yellow] areas have already happened."[165] In making these classifications, HOLC would often rely on the racial composition of the neighborhood. As a result, most neighborhoods with heavy minority populations, including in many large northern cities, were coded as areas that were declining or had already declined.[166]

Despite the racist characteristics of the federal government's administration of the HOLC program through redlining, private market actors reduced the adverse impact of government policies in restricting housing credit to Black borrowers.[167] One statistical analysis of mortgage lending patterns during the New Deal in Philadelphia concluded that private lenders continued

[162] See Charles Lewis Nier, III, The Shadow of Credit: The Historical Origins of Racial Predatory Lending and Its Impact Upon African American Wealth Accumulation, 11 U. Pa. J. L. & Social Change 131 (2007-2008).

[163] There were other racist elements, both *de jure* and *de facto*, of the New Deal. The Taskforce's narrow focus on the problems related to financial inclusion and government-sponsored discrimination is not intended to discount the intent or effects of New Deal government policies on Black families and others.

[164] *See* Nier, *supra* note 162, at 175.

[165] Nier, *supra* note 162, at 177.

[166] "For example, in Detroit, every neighborhood with any degree of African American population was rated 'D' or 'hazardous' by federal appraisers. Also, any location subject to 'infiltration' by 'an undesirable population' received a 'D' rating." Nier, *supra* note 162, at 179.

[167] *See* Amy E. Hillier, *Redlining and the Home Owners' Loan Corporation*, 29 J. of Urban Hist. 394 (2003).

to make some mortgage loans in redlined areas notwithstanding the federal government's racist policies. As Hillier summarizes her empirical findings, "These [regression] results confirm that lenders did not categorically redline areas that HOLC colored red. Households in all parts of the five sample areas succeeded in securing mortgages." She continues, "[T]he analysis does indicate that there was a significant amount of conventional mortgage activity in all parts of the city involving many different types of lenders. While these different types of lenders showed preferences for certain areas and types of properties, none categorically refused to lend to all red areas."[168] Indeed, it is unclear to what extent private lenders were even aware of the HOLC's lending maps much less used them in their loan decisions.[169]

While HOLC made loans in minority neighborhoods coded yellow and red, it used its control over the mortgage finance market to maintain racial segregation of neighborhoods.[170] "While HOLC does not appear to have avoided making loans to African Americans, Jews, and immigrants or to neighborhoods with concentrations of African Americans and immigrants, the agency did avoid making loans to African Americans in white areas."[171] Analyzing the long-term effects of redlining, Krimmel found that over the next thirty years, neighborhoods subjected to HOLC redlining experienced no net increase in housing supply whereas nearby neighborhoods experienced did.[172] Redlined areas also experienced large differential declines in population during that period.[173] Following the enactment of the Fair Housing Act, these differential neighborhood effects dissipated, yet the effects of those discontinuities in housing supply and population density persist.[174] Krimmel found similar adverse effects stemming from redlining for redlined neighborhoods that were homogeneously White at the beginning of the period.[175] The adverse effects of this government policy were much greater for Blacks, however, as Black neighborhoods were substantially more likely to be subjected to redlining than White neighborhoods.[176] Krimmel notes that although Blacks comprised only 8 percent of the sample

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[168] Hillier, *supra* note 167, at 409. She found that loans in redlined areas had interest rates that were slightly higher than elsewhere but it is possible that could be explained by differences in risk. *Id.*

[169] Id.

[170] Amy E. Hillier, Who Received Loans? Home Owners' Loan Corporation Lending and Discrimination in Philadelphia in the 1930s, 2 J of Planning Hist. 3, 19 (2003).

[171] Hillier, *supra* note 170, at 19.

[172] See Jacob Krimmel, Persistence of Prejudice: Estimating the Long Term Effects of Redlining, Working Paper (Nov. 2020).

[173] Id.

[174] Id.

[175] *Id.*

[176] *See id.* at 12.

population in 51 cities, 86 percent of Blacks in 1940 lived in a HOLC redlined. Ninety-two percent of Whites in the sample population lived in the most credit-restricted areas, but only 35 percent lived in in a HOLC redlined area.[177]

The detrimental racial impact of federal governmental policies became more pronounced as racist New Deal housing policies shaped migration patterns to the suburbs, especially in the post-War era. The Federal Housing Administration (FHA) was formed in 1937 to carry forward HOLC's initial emergency efforts to save homes from foreclosure into a government program to subsidize home ownership.[178] FHA's primary role was to insure private lenders against potential losses from mortgage lending and thereby to make possible lending with low down payments or longer loan terms (with lower monthly payments) than might otherwise be economically prudent.[179] To some extent, FHA's racially discriminatory effects arose from facially neutral policies: for example, FHA preferred to support new construction of detached single-family homes in suburban neighborhoods instead of urban homeownership, which mirrored the growing tendency of White families to relocate to the suburbs. On the other hand, FHA also expressly considered the racial homogeneity and composition of a neighborhood, even endorsing racially-restrictive covenants to preserve racial "harmony" and the overall stability of the neighborhood.[180] In fact, in the famous Levittown suburb, the FHA required as a condition for subsidizing the development that no homes could be sold to Black buyers and that each home in the development contain a racially-restrictive resale covenant.[181] According to the FHA's underwriting manual at the time, "if a neighborhood is to retain stability, it is necessary that properties shall continue to be occupied by the same social and racial classes."[182] The federal government's role in housing finance eventually shaped private mortgage lending policy more generally, as private lenders dramatically reduced their level of mortgage lending to Black borrowers.[183] As Richard Rothstein has observed, "[W]ithout federal policy designed explicitly with racial explicit intent to segregate every metropolitan area in this country,... private factors

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[177] *Id.* at 13, Table 2.

[178] *See* Nier, *supra* note 162, at 180-81.

[179] *See* Nier, *supra* note 162, at 180-81; *see also* Kevin Fox Gotham, *Racialization and the State: The Housing Act of 1934 and the Creation of the Federal Housing Administration*, 43 Sociological Perspectives 291 (2000); Richard Rothstein, The Color of Law: A Forgotten History of How Our Government Segregated America (2018).

[180] Nier, *supra* note 162, at 183

[181] Rothstein, *supra* note 179.

[182] *See* Kenneth T. Jackson, Crabgrass Frontier: The Suburbanization of the United States 208 (1985) (citing U.S. Fed. Hous. Admin., Underwriting Manual § 1301 (rev. Jan. 1, 1947).

[183] Nier, *supra* note 162, at 185.

[such as private prejudice or real estate agent steering] would not have been able to successfully segregate their communities."[184]

These discriminatory FHA policies appear to have contributed to lower home ownership rates among Black families by either excluding them from mortgages entirely or by forcing them to turn to more-expensive alternatives. As a result, these government-created barriers to homeownership by Black families are also reflected in the wealth gap between White and Black families.[185] For many middle-class and working-class families, home ownership represents a significant portion of their household wealth.[186] Subsequently, the United States Supreme Court invalidated racially-exclusionary covenants in housing[187] and Congress adopted the Fair Housing Act in 1968 that formally did away with the federal government's discriminatory lending mandates.[188] Although these laws eliminated government-mandated segregation they did not eradicate its historical legacy in housing or housing finance.

These government-created barriers to homeownership by Black families almost certainly have contributed to the continuing wealth gap between White and Black families.[189] For many middle-class and working-class families, home ownership represents a significant portion of their household wealth.[190] Depriving Blacks of the same opportunities could only have widened the wealth gap.

The Fair Housing Act and other social and economic developments appear to have largely eliminated government-sponsored discrimination in housing finance markets. For example,

[184] *See A Forgotten History of How the U.S. Government Segregated America,* Fresh Air (May 3, 2017), *available in* https://www.npr.org/transcripts/526655831.

[185] *See* Lisa J. Detting, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, and Jeffrey P. Thompson, *Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence from the Survey of Consumer Finances*, FEDS Notes (Sept. 27, 2017).

[186] 32 percent of household wealth for White families and 37 percent of wealth for Black families is in housing. *Id.* at Table 1. 73 percent of White families are homeowners compared to 45 percent of Black families. Average net housing wealth is more than twice as large for White families as for Black.

[187] Shelley v. Kraemer, 334 U.S. 1 (1948). The Supreme Court earlier invalidated local zoning ordinances enacted during the Progressive era designed to enforce racial segregation in housing policy on the basis that such laws violated principles of freedom of contract. *See* Buchanan v. Warley, 245 U.S. 60 (1917); *see also* David E. Bernstein, Rehabilitating Lochner: Defending Individual Rights against Progressive Reform 73-90 (2011).

[188] 42. U.S.C. § 3601, *et seq.*

[189] *See* Lisa J. Detting, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, and Jeffrey P. Thompson, *Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence from the Survey of Consumer Finances*, FEDS Notes (Sept. 27, 2017).

[190] 32 percent of household wealth for White families and 37 percent of wealth for Black families is in housing. *Id.* at Table 1. 73 percent of White families are homeowners compared to 45 percent of Black families. Average net housing wealth is more than twice as large for White families as for Black.

empirical studies conducted in the mid-1990s failed to find evidence of ongoing racial bias in FHA's mortgage lending program[191]

10.5.2 Discrimination and Equal Credit in Non-Mortgage Consumer Finance Markets

In addition to the intentional efforts of the federal government to maintain racial housing segregation, many Americans faced notable challenges to full inclusion in the post-War consumer finance revolution, especially minorities (mainly Black) and women. As economic historian Louis Hyman has noted, "Even as the credit problems of affluent, white women and poor, Black Americans emerged for different reasons and with different consequences, credit reformers lumped both as discrimination."[192] Although sometimes combined under the general heading of "discrimination," the historical and economic causes of unequal treatment varied and potential remedies to address those inequalities varied as well. Concerns about discrimination with respect to marginalized groups culminated in the passage of ECOA in 1974 that was intended to eliminate discrimination in the provision of credit.

Financial Inclusion and Black Consumers

The problem of unequal access and terms of credit by minorities arose from a complex and interlocking network of self-reinforcing economic and social conditions that reflected a long legacy of discrimination and economic exclusion. As noted by the NCCF, it can be difficult to distinguish the impact of racial discrimination from other factors that are often found together with race, such as lower incomes, less wealth, and more unstable unemployment.[193] Moreover, many of these other factors might themselves reflect the continued influence of prior historical patterns of discriminatory treatment. Regardless of the underlying causes of these disparities, eliminating the continued legacy of unequal outcomes should focus on not only eliminating discrimination but also reforming government policies and market institutions that generate and maintain exclusionary patterns.

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[191] *See* James A. Berkovec, Glenn B. Canner, Stuart A. Gabriel, and Timothy H. Hannan, *Race, Redlining, and Residential Mortgage Loan Performance,* 9 J. Real Estate Fin. and Econ. 263 (1994); James A. Berkovec, Glenn B. Canner, Suart A. Gabriel, and Timothy H. Hannan, *Mortgage Discrimination and FHA Loan Performance,* 2(1) Cityscape: A Journal of policy Development and Research 9 (Feb. 1996), *available in* https://www.huduser.gov/Periodicals/CITYSCPE/VOL2NUM1/berkovec.pdf..

[192] Louis Hyman, Debtor Nation: The History of America in Red Ink 173-74 (2011).

[193] *See* Walter E. Williams, *Why the Poor Pay More: An Alternative Explanation,* 52 Social Science Quarterly 375 (1973); *see also See* James J. Heckman, *Detecting Discrimination,* 12 J. of Econ. Perspectives 101 (1998) (noting similar phenomenon with respect to employment studies).

As discussed in Chapter 2, the rising prosperity and migration of middle-class, predominantly White families to the suburbs in the post-War era brought with it an unprecedented demand for mortgages and consumer goods, especially durable goods such as automobiles and modern household appliances. This rapid increase in demand for consumer goods and accompanying demand for consumer credit overwhelmed the traditional labor-intensive, subjective judgment-based system of credit evaluation by lending officers. The growing size and interstate nature of department stores and finance companies also brought with a desire for greater efficiencies and consistency in credit-granting decisions. These developments prompted the creation of prototype credit reporting and scoring models that enabled rapid and accurate assessments of a prospective customer's credit worthiness. In turn, the growing use of standardized credit scoring models prompted increased choice for consumers to shop for credit and increased competition and entry by new credit grantors. As noted above, because of the continued distorting effect of usury ceilings, much of the financing of the purchase of consumer durables was provided by retailers. Because shopping for goods and credit were often intertwined in the same transaction, pricing was not as transparent and competition was not as effective as it might otherwise be. Nevertheless, during the post-War era, middle-class consumers shopped in a robust market that provided high quality goods on competitive terms.

The experience of urban communities, especially those who lived in minority neighborhoods, was far different. Black families in large cities continued to disproportionately live and work in older housing and lower income commercial centers. The concentration of urban Blacks limited their opportunities, deprived them of the means to afford moves to wealthier neighborhoods, and reinforced the effects of government-imposed segregation in residential mortgage markets. Urban poverty and lack of economic opportunity created a self-reinforcing dynamic, a closed system that produced a separate and inferior selection of consumer credit sources, largely those from the retail sales industry. Because of their tight budget constraints, low income families were much more reliant than prosperous middle-class families on access to credit purchases of durable goods, and even many nondurable goods. Yet because they had lower incomes, less stable employment, and fewer assets, these consumers tended to present as having a higher risk profile to lenders. Prevailing usury ceilings and entry barriers made it economically infeasible for banks, finance companies, or credit unions to compete in low-income neighborhoods with higher-risk borrowers. For example, according to the NCCF Report, there were no small loan companies operating in Harlem or the District of Columbia at that time and credit unions had relatively few low-income members.[194] Retailers, however, could circumvent usury ceilings by increasing the price of the goods they sold on credit to higher-risk borrowers. This meant that higher-risk urban consumers were almost completely dependent on retailer-provided credit for

[194] *See* NCCF Report, *supra* note 2, at 180.

consumer purchases and there was virtually no competition from finance companies or other potential legal credit providers. As a result of this term repricing behavior by retailers, prices paid by low income consumers for products purchased on credit at neighborhood stores were substantially higher than for the same products purchased by middle-class consumers on credit elsewhere.

A study commissioned by the NCCF by economists George Day and William Brandt found that similar percentages of lower-income Whites (77 percent) and Blacks (83 percent) used dealer credit. With respect to upper-income households, however, 50 percent of upper-income Whites and 85 percent of upper-income Blacks used dealers.[195] Day and Brandt attribute the comparatively low degree of usage of dealer credit by higher-income Whites relative to the other groups to an increased propensity (or ability) to arrange their own financing through banks or finance companies.[196] By contrast, Day and Brandt concluded that low-income and minority consumers relied more heavily on dealer-provided credit than cash lending sources because they had limited access to cash lending sources or because they believed it would be difficult for them to obtain credit from those banks and finance companies.[197] Black consumers were also more likely than White consumers, on average, to make purchases on credit instead of cash and were less likely to have had prior experience with bank loans, bank credit cards, or charge accounts of any kind, which likely impacted the efficacy of their shopping behavior.[198]

The quality of goods purchased at stores serving lower-income communities also was often inferior to that offered to middle-class consumers. Moreover, because almost all higher-risk consumers were effectively forced to make a joint purchase of goods and credit, it was difficult for them to discern the true cost of either element of the transaction and therefore difficult to engage in comparison shopping. This combination of elements led to the widespread perception that retailers in urban neighborhoods were guilty of "selling… shoddy merchandise at high prices on credit with usurious rates."[199]

Researchers have found evidence that supports the perception. According to David Caplovitz in his famous book, *The Poor Pay More*, 75 to 90 percent of purchases of household goods by low-

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195 George S. Day and William K. Brandt, A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation, 1 National Commission on Consumer Finance Studies 82. Vol. 1 (1972); *see also* NCCF Report, *supra* note 2, at 180.

196 Day and Brandt, *supra* note 195, at 83.

197 Day and Brandt, *supra* note 195, at 102. Day and Brandt do not determine the accuracy of that perception.

198 Id.

199 Hyman, *supra* note 192, at 175.

income households were made on credit.[200] Similarly, a 1968 Federal Trade Commission study found that 93 percent of household goods sales to low-income households were made on credit compared to 27 percent of purchases in "general" goods markets.[201] Moreover, the FTC found that although the stated average finance charge on credit provided by low-income and "general" market retailers was comparable, the mark-up price on their products was 2.55 times the wholesale price at low-income retailers versus only 0.59 times at general market retailers. 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.

Why did lower-income families not leave their neighborhoods to shop at less-expensive stores elsewhere? Primarily because they would have been unable to obtain credit there as a result of discrimination. As Hyman notes, "Local neighborhood merchants offered them credit that many poorer consumers could not get at the lower-priced downtown or suburban stores."[202] Because they could buy on credit at local stores but not elsewhere, lower-income minority consumers were able to shop more effectively at those stores, according to Hyman. But stores that specialized in serving lower-income neighborhoods often operated outside the mainstream of consumer finance; thus, shopping at those specialized stores meant that lower-income consumers remained largely invisible to the organized credit reporting system.

According to Hyman, "Without credit references, much less credit ratings, downtown stores would not extend" credit to lower-income minorities, which reinforced their dependence on local merchants.[203] Moreover many "downtown" department stores shunned Black patrons whereas local stores, typically Black-owned and operated, welcomed them.[204] Boxed in on one side by lower-priced "downtown" department stores that did not want to serve them, by their inability to obtain credit because they lacked credit references, and by usury ceilings and entry barriers that foreclosed competition from finance companies and other cash credit providers, lower-income minority consumers were locked in a self-perpetuating cycle of growing dependence on local stores that provided credit on anticompetitive terms. As Hyman argues,

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[200] David Caplovitz, The Poor Pay More 16-20 (1967). Caplovitz's study was originally published in 1963.

[201] *See* Federal Trade Commission, Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers (1968); *see also* Durkin, et al., *supra* note 25, at 514.

[202] Hyman, *supra* note 192, at 176.

[203] Hyman, *supra* note 192, at 176 ("Credit tied lower-income consumers to neighborhood merchants, who enabled them to buy more, but at higher prices.").

[204] *See* Traci Parker, Department Stores and the Black Freedom Movement: Workers, Consumers, and Civil Rights from the 1930s to the 1980s at p. 15-25 (2019).

"The necessity of consumer credit to buy modern merchandise on a limited income bound poorer consumers to local merchants, who charged higher prices and higher interest rates than the merchants in more affluent areas."[205]

Thus, what was often characterized as a lack of diligence or understanding by lower-income consumers in engaging in comparison shopping may have reflected a lack of incentives to shop as a result of the limited benefit that would be obtained from doing so in light of their restricted choices.[206] Instead of competing on the price of credit, as middle-class retailers did, lower-income merchants competed mostly on ease of credit terms. Day and Brandt found that lower-income and higher-risk consumers showed less awareness of APRs than higher-income, more highly-educated, and lower-risk consumers, which suggests that marginal consumers had reduced incentives to shop on the basis of APR than access to credit.[207] In addition, heavy reliance of lower-income and higher-risk retail credit reduced these consumers' ability to shop on the basis of APR because the price of credit was often obscured by bundling it into the price of the goods.[208] Thus, the same research found that almost all buyers knew the maturity, amount financed, and monthly payment associated with their credit.[209]

Despite charging high prices, merchants in lower-income neighborhoods actually earned lower returns on investment than mainstream competitors.[210] Costs of operation and default losses were high. One reason for high defaults was the feeling by some borrowers that they had been given a raw deal—the shoddy goods they received did not justify the high prices and finance charges they paid.[211] As a result, borrowers sometimes simply stopped paying. To contain high losses in the face of high default rates, lower-income merchants insisted on providing credit on

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205 Hyman, *supra* note 192, at 176.

206 *See* NCCF Report, *supra* note 2, at 179-180 (attributing lack of awareness by lower-income households of rates on credit union loans to the fact that credit unions had very few low-income members).

207 Day and Brandt, *supra* note 195. As suggested above, the lack of experience with mainstream financial providers also reduced the knowledge base and efficacy of shopping behavior by low-income minority consumers that created a self-reinforcing negative feedback loop with respect to shopping behavior. *Id.*

208 *See* NCCF Report, *supra* note 2, at 182 ("Nor does this represent 'irrational' behavior on the part of consumers. The dominance of the cash price in the total time price, the scarcity of legal cash credit, and the ability of retailers serving low income consumers to blur the level of the finance charge by stretching maturities or raising cash prices, causes these consumers to place little reliance on the disclosed APR in their shopping."). Consumers also often expended more energy and attention shopping for the underlying product, such as its price and quality attributes, than on the credit element of the sale.

209 *Id.* Day and Brandt found that when shopping for credit, credit-rationed consumers were much more likely to focus on the size of a required down payment and the maturity of a credit offer than those who were unconstrained. *See* Day and Brandt, *supra* note 195.

210 *See* NCCF Report *supra* note 2, at 181 (citing Federal Trade Commission, *supra* note 201).).

211 Hyman, *supra* note 192, at 178.

an installment basis with the goods serving as collateral that lenders could repossess upon default.[212] Merchants serving lower-income consumers also aggressively pursued legal remedies for unpaid balances. These practices differed dramatically from those of mainstream department stores, which by this time had largely adopted unsecured revolving charge accounts and rarely sued for unpaid balances.[213] These troubles associated with default, repossession, and subsequent lawsuits fed back into the troubles of lower-income consumers, further undermining their ability to shop and obtain credit from stores outside their local neighborhood.

One step toward breaking this cycle of financial exclusion and mistreatment was the passage of ECOA, which outlawed discrimination in credit granting on a variety of impermissible factors. But it was widely recognized that banning discrimination, while important, would be insufficient to reverse the effects of a long historical legacy of societal discrimination and lack of economic opportunity that had become embedded in market structures and institutions. Thus, reformers also considered affirmative and proactive policies to try increase access for low-income and minority consumers. These approaches focused especially on promoting competition and entry by new providers that would reduce the dominant position held by local retail merchants in credit granting and enable minority consumers to become less dependent on exploitative local providers. Remedies to increase choice and competition focused on two basic approaches: to either bring greater competition *into* the local neighborhood by increasing the quality and quantity of competitors in the neighborhood or to help low-income minority consumers to shop *outside* of the neighborhood at the same stores and financial providers as middle-class consumers by improving their credit options.

Bringing competition to urban neighborhoods required eliminating existing barriers to competition and supporting potential new entrants. The most obvious target was the elimination of usury ceilings and barriers to entry (such as "convenience and advantage" requirements for opening a new small-loan company) that made it economically infeasible for banks and finance companies to operate profitably. Because of these limits on pricing and entry, only companies that could successfully circumvent usury ceilings by burying credit costs in overpriced goods could survive in urban areas. But, as noted, this created market power in the hands of local retailers and made pricing less transparent by tying together credit transactions and purchases of goods. Supporters of this strategy argued that opening the local market to greater competition, including from banks, finance companies, and mainstream department

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[212] *See* Hyman, *supra* note 192, at 178; *see also* Martha L. Olney, *When Your Word is Not Enough: Race, Collateral, and Household Credit,* 58 J. Econ. Hist. 408 (1998) (finding that during the 1920s Black families were about twice as likely to use installment credit as White families even though overall amounts of credit extended were comparable between the two groups).

[213] *See* Hyman, *supra* note 192, at 178.

stores would drive out of business exploitative retailers and replace them with lower-priced and higher-quality providers.[214] Eliminating restrictions on branch banking that prevented entry by successful banks that might want to expand operations into lower-income communities was also urged.[215]

A related, but inconsistent strategy, involved building up new locally owned retailers and banks into viable competitors to the exploitative retailers. Usually this meant a primary focus on providing credit to promote small-business lending that would encourage local economic development, with provision of consumer finance a secondary consideration. This strategy of building up local competitors was in inherent conflict with the strategy of encouraging entry by firms from outside the neighborhood, as encouraging outside competitors to enter and supplant incumbent providers would dramatically increase access to credit but shift economic control outside the neighborhood while building up local institutions would have the opposite effect.

Efforts to promote Black-owned banks and retail businesses date back to the 19th century.[216] During much of the 19th century, Blacks in America relied on a variety of informal financial relationships to meet their credit and banking needs as well as loans from churches, schools, and fraternal orders and secret societies.[217] Although the idea of a Black-owned bank was first discussed prior to the Civil War,[218] the first bank was not established until 1888, through the direct and indirect funding of mutual aid societies that evolved during Reconstruction with the primary goal of supporting the economic and social prospects of freed slaves.[219] The mission of these banks was to provide capital and credit to new businesses (especially service-oriented businesses in the Black community), to finance special projects sponsored by fraternal and mutual aid societies, and "to provide general banking services to the African American community, which had been ignored by most non-minority-owned banks."[220] From 1888 to 1928, these banks "served as the major outlet for African Americans to gain access to loans and other banking services. This was particularly important because the majority of the non-

[214] As suggested by the findings of the FTC's Report, however, the low rate of investment return for incumbent stores operating in inner cities reduced incentives for new stores to enter local markets.

[215] Hyman, *supra* note 192, at 185.

[216] *See* Erik Johnson, *The Black Department Store on King Drive,* Chicago Crusader (Feb. 232, 2018), *available in* https://chicagocrusader.com/the-black-department-store-on-king-drive/.

[217] *See* Tim Todd, Let Us Put Our Money Together: The Founding of America's First Black Banks 1-19 (2019).

[218] Id.

[219] See Lila Ammons, The Evolution of Black-Owned Banks in the United States Between the 1880s and 1990s, 26 J. of Black Studies 467 (1996); see also Amber Burton, Justin Scheck, and John West, The Battle to Keep Black Banks Alive, Wall St. J. at p. B1 (Nov. 7-8, 2020).

[220] Ammons, *supra* note 219, at 471.

minority-owned banks in existence during this era were unwilling to provide basic financial services to the African American community."[221]

During the turbulence of the Great Depression, World War II, and the post-War era, Black-owned banks faced many challenges with an unstable banking system, a loan portfolio with a higher percentage of bad loans, inexperienced management, thin capitalization, and a customer base with limited assets and collateral. More fundamental, Black-owned banks typically had higher costs and lower returns than White banks because of the small average size of their depositors' account balances and personal loans as well as the absence of large commercial checking accounts.[222] Moreover, opportunities for profitable reinvestment in the local community were scarce, leading many minority-owned banks to seek investment opportunities elsewhere. As a result, the prospect for Black-owned banks to become substantial viable rivals to established institutions was improbable.[223] Although the number of smaller banks has declined nationwide since the enactment of the Dodd-Frank Act, the impact of increased regulatory costs has been especially severe for minority-owned banks.[224]

The alternative approach involved enabling lower-income consumers to leave the local neighborhood to bank and shop in middle-class neighborhoods. This approach focused on developing the credit visibility of lower-income consumers and to help them establish credit records. Washington Urban League executive director John Jacob proposed the creation of a "credit card for urban residents" that would enable residents of low-income, minority neighborhoods to shop at any store they wanted, including in White areas without having to worry about the additional obstacle of credit approval.[225] According to Jacob, revolving credit cards also would meet the needs of low-income urban consumers better than traditional installment loans because credit cards' flexible payment terms were more suitable to the higher income volatility of the urban poor. According to Hyman, Jacob believed "The unyielding fixed repayment plans of installment credit frustrated [low-income minority] consumers, whose paydays could be as irregular as the debt due dates were regular."[226] Interest rates on credit cards, unlike department store installment credit, also could vary according to the borrower's degree of risk. Jacob also believed, wrote Hyman, that most residents of low-income minority communities "cared more about their own access to flexible credit than whether the lender was

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[221] Id.

[222] Hyman, *supra* note 192, at 184-85; *see also* Ammons, *supra* note 219219.

[223] Ammons, *supra* note 219, at 474-75.

[224] *See* Burton, Scheck, and West, *supra* note 219219.

[225] Hyman, *supra* note 192, at 188.

[226] *Id.* at 189

black or white."[227] Encouraging existing mainstream institutions to serve minority neighborhoods was another measure that Jacob thought would lead banks to rethink their negative stereotypes of Black consumers and would help urban residents to overcome their traditional distrust of traditional banks.[228] This would create a virtuous cycle of greater trust by lower-income consumers for established financial providers and greater interest by financial providers in serving this market.

Stark differences remain today in the financial conditions of minority households in America compared to White households. Black and Hispanic households are more likely to be unbanked than White households.[229] Although the unbanked rate has fallen steadily over the past several years as the economy has recovered from the Great Recession, it fell more rapidly than average for Black and Hispanic households.[230]

Minority households also have lower net wealth on average than White households.[231] From 2016-2019 the growth rate in net wealth was dramatically higher for Black (33 percent) and Hispanic families (65 percent) than White families (3 percent), after suffering larger than average drops in wealth during the Great Recession.[232] Despite these recent gains, however, there remains a significant wealth gap between White and minority households on average. Homeownership rates are significantly higher for Whites than for minorities, and their home values are higher on average.[233] This difference in homeownership rates and values reflects in part the legacy and persistence of housing discrimination and segregation patterns, including policies promoted by the federal government. The difference also partly reflects the deeper intergenerational wealth of White families, as many young homeowners receive contributions from their parents to make their initial down payment.[234] Black and Hispanic families are both less likely to have access to a retirement plan and, contingent on access, less likely to participate than White families. Black and Hispanic families, on average, have less money saved for short-

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227 Id.

228 *Id.* at 190

229 Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 27-28.

230 2019 FDIC Survey, *supra* note 129, at 1.

231 Neil Bhutta, Andrew C. Chang, Lisa J. Dettling, and Joanne W. Hsu, *Disparities in Wealth by Race and Ethnicity in the 2019 Survey of Consumer Finances*, FEDS Notes, (Sept. 28, 2020).

232 Id.

233 *Id.*

234 *Id.* According to research by the Federal Reserve Board, 62 percent of renters state that the inability to afford a down payment is their primary reason for renting compared to only 41 percent who state it is because they are unable to qualify for a mortgage. *See* Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 33.

term emergencies as well.[235] Blacks and Hispanic households are less likely than White households to have a credit card.[236]

Recent research has attributed the persistence of the racial wealth gap primarily to the racial income gap, which compounds the dynamics of wealth accumulation over time.[237] Different levels of educational attainment by racial and ethnic background contribute to these income differences. The role of intergenerational wealth transfers also contributes to a perpetuation of wealth inequality across generations in multiple ways, including enabling larger investments in higher education without incurring student loan debt, assistance in providing a down payment for a house purchase, having family members with greater resources to fall back on in case of a financial emergency, and most obviously, larger inheritances and bequests.[238]

Racial and ethnic differences in approaches to saving and investing might also have an effect on differential rates of wealth accumulation over time. Minority households historically have been more likely to invest in housing than financial investments than White households, apparently because of lower levels of risk tolerance.[239] To some extent, this lower risk tolerance may reflect a natural response to lower initial wealth baselines for minority households resulting from historical disadvantages. But because the average return on financial investments exceeds that of housing over time, a preference for investing in housing tends to compound initial wealth differences between minority and White households over time. Racial differences in educational levels may influence relative rates of wealth accumulation because more highly-educated individuals tend to be more confident and more knowledgeable about investment decisions and thus more likely to invest in higher-risk, higher-yield investments than less-educated individuals.[240] Hanna, et al., observe that minority households may be less risk tolerant in financial decisions because of lack of familiarity with financial investments rather than

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[235] *See* Bhutta, et al., *Disparities in Wealth, supra* note 231.

[236] Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 27-28.

[237] *See* Dionissi Aliprantis and Daniel R. Carroll, *What is Behind the Persistence of the Racial Wealth Gap?*, Federal Reserve Bank of Cleveland Economic Commentary No. 201903 (Feb. 28, 2019), *available in* https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2019-economic-commentaries/ec-201903-what-is-behind-the-persistence-of-the-racial-wealth-gap.aspx.

[238] *See* Fabian T. Pfeiffer and Alexandra Killewald, *Multigenerational Correlations in Family Wealth*, 96 Social Forces; A Scientific Medium of Social Study and Interpretation 1411 (2017).

[239] *See* Sharmila Choudhury, *Racial and Ethnic Differences in Wealth and Asset Choices*, 64 Social Security Bulletin No. 4 (2001/2002), *available in* https://www.ssa.gov/policy/docs/ssb/v64n4/v64n4p1.html; *see also* Sherman D. Hanna, Cong Wangt, and Yoonkung Yuh, *Racial/Ethnic Differences in High Return Investment Ownership: A Decomposition Analysis*, 21 J. of Financial Counseling and Planning 44 (2010).

[240] Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 51.

substantive differences in risk tolerance.[241] This suggests a potentially valuable role for financial education, as building financial understanding and capability could increase confidence to invest in higher-yielding investments that could build more wealth over time. Because a variety of social, demographic, and educational factors appear to be tied in with decisions that affect income and wealth, more research on the potential relationship between racial and ethnic background on financial decision-making would be useful.[242]

Unequal Treatment Based on Sex and Marital Status

Unequal treatment based on sex and marital status raised distinct issues from unequal treatment based on race. Both had ancient roots in economic, social, legal, and political systems, but the battles for reform were fought separately until the 1950s and 1960s. Persistent racial injustice ultimately ignited the Civil War and the emancipation of the slaves in the nineteenth century. A half century later the suffrage movement secured the right of women to vote. By then, tragically, the nation had breached many of the promises of emancipation, including property rights, equal access to education, and unimpeded access to the ballot box. Blacks who escaped the oppression of Jim Crow could not escape the poverty that followed them into segregated communities of the north.

It was not until the country emerged from World War II that the movements began to converge. They did in the 1960s, when the rising economic and political power of professional women and the growing political and social influence of the feminist movement[243] joined the undeniable appeals for social justice and equal opportunity for Blacks. The movements catalyzed reforms for not just equal treatment in credit granting but also for the eventual adoption of more objective determinations of creditworthiness based on credit reporting information rather than reliance on the subjective evaluations and potential biases of individual loan officers.

At the proceedings of the NCCF, the most significant inclusion issues confronting women appeared related to marital status. such as creditors being unwilling to extend credit to a married woman in her own name, requiring women (but not men) to reapply for credit after getting married, and particular difficulty for separated, divorced, or widowed women in establishing credit.[244] As Hyman observes, "The existence or lack of individual credit histories

[241] Hanna, et al., *supra* note 239, at 46.

[242] Minority and immigrant populations in the United States tend to be younger on average than Whites, thus some of these aggregate differences also reflect differences in age and opportunity for lifetime wealth accumulation.

[243] Hyman, *supra* note 192, at 193.

[244] NCCF Report, *supra* note 2, at 152-53.

for women drove many of the differences in credit access between single, married, and divorced women."[245]

As early as the 1920s, department stores "had readily provided charge cards to single women who had sufficient income to qualify."[246] Although women faced disparagement from moralists and merchants for their borrowing, they outnumbered men in stores, pawnshops, and lending offices.[247] Most likely they faced discrimination by individual loan officers at particular firms. Luckily, there were plenty of department stores and other lenders who were happy to underwrite single women with sufficient income and character to qualify.[248]

Problems really began, however, when a single woman married, at which point her credit identity was merged into her husband's and her prior credit history disappeared. In many cases, a married woman had to reapply for credit under her husband's name at department stores where they had previously been granted credit. Although this was unlikely to affect overall credit access (except when the wife earned higher income than her husband), it was highly humiliating, especially for affluent professional women who were simultaneously fighting for equality in the workplace. For women who valued their own rights, Hyman observes, "credit dependency on their husbands was a tangible reminder of how institutions defined them as an economic appendage of their husbands."[249] Access to credit in their own names was for professional married women, "not a strategy of survival but an expression of class privilege, economic independence, and pride."[250] The stated rationale for this practice was the belief by credit grantors that married women "usually" would have children and drop out of the workforce.[251] Therefore, relying on their husband's income and creditworthiness was considered a more reliable foundation for credit granting decisions than the wife's former income. In some instances, however, discrimination was more a reflection of the culture and practices of low-level loan officers than company policy.[252]

For divorced and widowed women, however, the problems took on serious economic dimensions, as well as legal and societal complications. Because their credit record from when

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[245] Hyman, *supra* note 192, at 193.

[246] Id.

[247] See, e.g. Chapter 8, Appendix B (citing sources).

[248] Id.

[249] Id.

[250] *Id.* at 203.

[251] Id.

[252] *Id.* at 201.

they were single was extinguished when they married, following divorce they appeared to have no credit record at all. Moreover, if they had stopped working while married, they would have little income to report. Prevailing underwriting standards excluded alimony and child support payments as income, even though for many women with younger children, those payments were their primary source of income.[253] Making matters worse, divorce often was correlated with a higher risk of default, and even if the newly-divorced woman was not granted credit in her own name, she could be held jointly responsible for debts incurred while married.

Recognizing the economic opportunity presented by the growing economic clout of working women, by the early 1970s many lenders began to alter their lending practices to tap this growing market.[254] Indeed, some banks directed their marketing to women to sell their financial services and take market share from lenders who neglected or discriminated against them. At the same time, effective and influential feminists were pushing for legislation that would require loans to be made on the basis of individual credit histories and other more-objective criteria rather than demographic stereotypes.

Today, there are few systematic differences in the finances of women and men, and the differences seem related to factors other than bias in credit markets. According to a recent report by Experian, women's and men's FICO scores are nearly identical.[255] Men overall carry 21.7 percent more debt than women overall and carry higher levels of mortgage, auto, and personal loan debt than women. Student loan debt levels are nearly identical. Women have more open credit card accounts then men but carry less credit card debt. Some research suggests that men and women might have different attitudes toward debt and financial risk, which might explain some of these differences in the willingness of men to incur higher levels of debt.[256]

Determining the extent and causes of wealth differences between men and women is difficult, largely because differences in wealth-building between married and unmarried households swamps differences between sexes within those categories.[257] Between never-married men and women, however, a wealth gap still exists. This is largely because of an income gap between men

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[253] *Id.* at 198.

[254] *Id.* at 201.

[255] *See* Brianna McGurran, *Women and Credit 2020: How History Shaped Today's Credit Landscape,* Experian.com (Feb. 28, 2020), *available in* https://www.experian.com/blogs/ask-experian/women-and-credit/.

[256] *Id.*; *see also* Bijou Yang and David Lester, *Correlates of Credit Card Ownership in Men and Women,* 96 Psychological Reports 912 (2005).

[257] *See* Erin Ruel and Robert M. Hauser, *Explaining the Gender Wealth Gap,* 50 Demography 1155 (2013). In fact, because women tend to marry men who are older than them at the time of marriage, marriage typically results in an immediate wealth increase for women.

and women that has compounded into wealth differences over time.[258] In part, the lifetime income gap for never-married women reflects historical patterns of women's occupations such as teaching and nursing that are less financially-remunerative and generate lower rates of return on investments in education, despite those professions being essential.[259] As women have gained access to higher-paying professions over time, the contribution of this factor to differences in lifetime income can be expected to decline.

Compared to men, women have been found to be more risk-averse in investment decisions[260] and express lower levels of confidence in their ability to make investment decisions,[261] leading them to prefer less-risky but less-rewarding investment strategies over time.[262] As with minority consumers, women may be more risk-averse in investment decisions because historically they have earned lower incomes and have less wealth to risk, or because they perceive more uncertainty about future earnings. Differences in risk tolerance between men and women might also be attributable in part to cultural factors.[263] This difference suggests a potentially valuable role for financial education in helping to build greater financial knowledge among women to increase their confidence to invest in higher-yielding financial investments that could more effectively build wealth over time. As marriage and household formation takes place at steadily later ages today, and as an increasing number of Americans do not marry at all, understanding the nature and causes of wealth differences between men and women is an increasingly important topic of research.

10.5.3 ECOA

The NCCF's hearings on equal credit access inspired even more women to lobby for legislation to prohibit the improper use of sex and marital status in credit decisions.[264] Starting at the state and local level, this effort culminated in the passage of the ECOA a few years after the NCCF Report was produced.

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[258] Id.

[259] *Id.* Women with children, of course, are also more likely to experience career interruption and competing pressures from family obligations than men.

[260] *Id.*

[261] Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 52.

[262] As noted above, these differences in orientation toward financial risk also might explain the willingness of men, on average, to take on more debt than women. *See supra* note 256 and accompanying text.

[263] See Robert A. Olsen and Constance M. Cox, The Influence of Gender on the Perception and Response to Investment Risk: The Case of Professional Investors, 2 J. Psych & Fin. Markets 29 (2010).

[264] Hyman, *supra* note 192, at 203.

A major effect of ECOA was an acceleration in the substitution of credit scoring models in making credit determinations in place of the subjective and sometimes biased assessments of low-level loan officers. ECOA, as Hyman put it, led to the final replacement of the traditional "C's" of credit granting with a sixth "C" - the "computer."[265] As discussed above, the emergence of credit bureaus and the adoption of credit scoring increased competition and dramatically expanded access to financial services for traditionally excluded groups. According to a 2007 report by the Federal Reserve Board, between 1983-2004 the prevalence of ownership of bank-type credit cards increased by at least 25 percentage points across every racial and ethnic group, and the gap between Blacks and Whites for all types of credit narrowed during that period.[266] Other research by the Federal Reserve found that the use of credit scores in underwriting and pricing of consumer credit and mortgages does not create a disparate impact by race or gender, although it does have a limited disparate impact by age of lowering the credit scores of older individuals and increasing them for the young.[267]

With respect to women, ECOA likely had its greatest impact with respect to eliminating discrimination against divorced and widowed women. By accelerating the adoption of objective criteria and credit-scoring models for credit underwriting, ECOA also eliminated the subjective assessments of loan officers who in the past might have had power to discriminate based on sexist stereotypes. To some extent, technological advances and market forces were making automated underwriting increasingly reliable and efficient, regardless of ECOA, but the law likely accelerated those economic trends that were reducing barriers to access for married women.[268]

Empirical evidence of the overall effect of ECOA on addressing discrimination in consumer lending markets has been mixed.[269] While ECOA has had economic and social benefits, it has also had costs.[270] Subsequent empirical studies found ECOA overall effect of ECOA led to a reduction in overall number of loans that were made and to increase the number of bad loans

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[265] *Id.* at 212.

[266] Report to Congress, *supra note* 126, at 44.

[267] *See* Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Does Credit Scoring Produce a Disparate Impact?,* Federal Reserve Board Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affair, No. 2010-58 (Oct. 12, 2010).

[268] *See* discussion at *supra* note 254 and accompanying text.

[269] Contemporary empirical studies found some evidence of discrimination with respect to age and marital status. *See* discussion in Durkin, Et al., *supra* note 25, at 441-46.

[270] *See* Bernard A. Shinkel, *The Economics of Discrimination in the Granting of Credit,* 9 Rev. of Black Pol. Econ. 416 (1979); James F. Smith, *The Equal Credit Opportunity Act: A Cost/Benefit Analysis*, 32 J. Fin., Papers and Proceedings of the Thirty-Fifth Annual Meeting of the American Finance Association 609 (1977).

made.[271] In addition, several studies found that ECOA and Regulation B increased costs for financial institutions.[272] Moreover, women were often better credit risks than men, so by excluding consideration of sex ECOA might have had the unintended consequence of disadvantaging some female credit applicants.[273]

Beyond its economic effects, ECOA has also held important symbolic value and has created a worthy standard and benchmark. At the same time, some of the concerns that animated ECOA, such as discrimination based on marital status, appear somewhat archaic today. Indeed, ECOA itself might have contributed to the obsolescence of those ideas. In light of the changes in society and the economy in the 50 years since ECOA's enactment, the Taskforce recommends that Congress and regulators examine ECOA's provisions and implementing regulations and consider updating certain limits and requirements that now seem outdated or seem to provide minimal continued benefit relative to their costs. The passage of time has also revealed certain new challenges that suggest the need for potential updating of ECOA. For example, the invention of in-vitro fertilization and other reproductive assistance technologies has given rise to financial products to fund those expensive procedures. Although the Taskforce is unaware of rigorous empirical studies on point, comments received by the Taskforce suggest that loans for assisted reproduction procedures might be disproportionately sought by women. More generally, this example illustrates the value of periodically revisiting ECOA for possible updates and amendments as social practices and economic conditions evolve.

Changes in social values during the past 50 years also suggest the desirability of expanding ECOA's principles to new classes of Americans who originally were not included, such as people with disabilities. Although some issues involving disabilities and financial services are addressed by the Americans with Disabilities Act ("ADA"), submissions to the Taskforce indicate that there are additional issues related specifically to credit-granting and financial services that are not. For example, working-age households in which the householder has a disability are more likely to be unbanked than average.[274] The Taskforce believes Congress and regulators should examine ECOA and consider updating it to cover new situations and classes of covered persons while also

[271] Durkin, Et al., *supra* note 25, at 447 (summarizing studies)

[272] *See* Durkin, Et al., *supra* note 25, at 448, n. 41 (summarizing studies).

[273] *See* Durkin, Et al., *supra* note 25, at 447 (discussing Gary C. Chandler and David C. Ewert, Discrimination on the Basis of Sex under the Equal Credit Opportunity Act (Purdue University Credit Research Center Working Paper No. 8, 1976).

[274] 2019 FDIC Survey, *supra* note 129, at 1-2. The percentage of disabled households with bank accounts remained about 18 percent from 2011-2017 but declined by two percentage points between 2017-2019. *Id.*

identifying provisions that are now largely obsolete or ineffective, which could be deleted or modified.

Competition, Price Controls, and Discrimination

For most consumers in American history, facially neutral laws such as usury regulations have been the primary obstacle to greater financial inclusion. Complicated price control regulations have limited the ability of commercial banks to satisfy consumer demand while at the same time segmenting markets and limiting competition among products and providers. Still later, legal limits on competition in the form of "convenience and advantage" laws sometimes further limited entry and competition, especially with respect to lower-income and higher-risk borrowers. In practice, the laws tended to disadvantage traditionally excluded groups and by stifling competitive pressures, might have facilitated discriminatory practices.

Although not directly targeted at racial minorities, immigrants, younger consumers, and women, the adverse consequences of usury ceilings fell most heavily on members of those groups. As noted, prior to the effective deregulation of credit cards in the *Marquette* case, many banks viewed credit cards as money-losing courtesy products to be provided to wealthier professionals who were larger customers of the bank and who maintained larger deposits or used other profitable bank products such as car loans or mortgages. Banks also made personal loans available to higher-income borrowers that were not available to the general public. Access to overdraft protection historically was seen as a "courtesy" product that banks extended to higher-income bank customers instead of declining payment of their transactions.[275] Meanwhile, lower-income families with less-established credit and fewer personal connections were left to struggle with retail store credit, personal finance company loans, and even illegal loan sharks. To the extent that certain sociodemographic groups were overrepresented in these income and risk groups (such as immigrants and minorities), these facially neutral regulations also had the incidental effect of disproportionately impacting those groups as well.

One notable way in which consumers and card issuers circumvented usury ceilings was by providing credit cards to customers who maintained larger deposits, had personal connections, or were able to purchase other bank products. Even without any presence of racially discriminatory intent, all of these market adjustments tended to favor established, upper-class white men and to disadvantage minorities, immigrants, women, and others who lacked the liquidity to pay higher annual fees or down payments or lacked the personal connections to gain preferential access to those products. This preferential access to credit for higher-income Whites

[275] *See* Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 69 Wash. & Lee L. Rev. 1141 (2012).The advent of automated overdraft protection underwriting systems has enabled overdraft protection to be made available to virtually all customers who request it. *Id.*

is consistent Day and Brandt's finding, reported above, that higher-income Whites were much less likely to use dealer-provided credit for purchasers than lower-income Whites or Blacks (regardless of income) and more likely to obtain credit on their own from a bank or personal finance company.[276]

But usury regulation also might have facilitated intentional racial discrimination as well. One consequence of usury regulations was to create a shortage of access to financial services, or "rationing." Rationing occurs when demand for a good or service exceeds supply at the market price - that is, when people who can afford to pay the price are nonetheless unable to buy what they desire. The presence of excess demand at the regulated price forced lenders to select which applications would be accepted. As noted, this discretion tended to favor friends and family of bank officials, who were disproportionately white, upper-class men. At the same time, holding creditworthiness equal, the presence of excess demand reduced the cost of discriminating against applicants who the bank or its employees might disfavor for some discriminatory reason, such as race.[277]

Economists have argued that where discrimination exists, it tends to be more prevalent and persistent in monopolistic industries than in competitive industries.[278] This tendency may be particularly strong in markets characterized by government-created regulatory barriers to entry and competition.[279] Studies have found that during the long period of government prohibition on branch banking and other barriers to competition, banks acted much like monopolistic enterprises in other industries, performing at suboptimal levels of efficiency and dissipating profits through inflated employee salaries and staffing, shorter working hours (i.e., "banker's hours"), and some evidence of discriminatory hiring and promotion practices. Consistent with the prediction from other labor markets, Black and Strahan found increased competition in banking markets through relaxation of government barriers to entry reduced prior disparities between men and women employees in pay and promotion.[280] The federal government's ability to maintain racial segregation in housing finance markets for decades is illustrative. Long-term

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[276] *See* discussion at *supra* notes 195-198 and accompanying text.

[277] Although the Taskforce has been unable to locate any literature on this point that specifically analyzes consumer lending markets, minimum wage laws similarly create labor market surpluses that enable discrimination by potential employers. *See* Thomas Sowell, Markets and Minorities (1981).

[278] *See* Gary Becker, The Economics of Discrimination (2d ed., 1971).

[279] *See* Armen A. Alchian and Reuben A. Kessel, *Competition, Monopoly, and the Pursuit of Pecuniary Gain, in* Aspects of Labor Economics 157 (National Bureau of Economic Research 1962), *available in* https://www.nber.org/chapters/c0605.pdf.

[280] Sandra E. Black and Philip E. Strahan, The Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry, 91 Am, Econ. Rev. 814 (2001).

discriminatory outcomes are less likely in competitive markets.[281] With respect to bank accounts, for example, Celerier and Matray found that elimination of barriers to interstate branch banking resulted in an increase in access to bank accounts for low-income households in general, but the effect was particularly large for Black households living in states with a history of discrimination.[282] Other studies have found increased competition in consumer credit markets reduces disparities in access to and the terms of consumer financial products.[283] For example, one recent study concluded that Latino and Black borrowers paid higher mortgage prices and were more likely to have their loan applications rejected in less competitive markets and that increased competition, in this case the entry of FinTech mortgage lenders into the market reduced or eliminated price disparities in the market.[284]

Thus Butler, et al., examined auto dealer financing markets and found that disparate pricing for minorities was more common in markets where auto dealers faced less competition from banks.[285] The authors also found no evidence of disparate treatment in applications for credit card loans for the same group of minority borrowers who received disparate pricing in the context of auto loans.[286] Brevoort also found no evidence of systematic racial differences in credit card access.[287] Butler, et al., conclude that these findings suggest that loans made in a face-to-face context, such as auto dealer-facilitated credit, may be more prone to disparate treatment than those made through an impersonal algorithmic process, such as credit cards.[288]

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[281] *See* Becker, *supra* note 278; Kenneth J. Arrow, *The Theory of Discrimination, in* Discrimination in Labor Markets 3, 20 (Orley Ashenfelter and Albert J. Rees eds., 1973).

[282] *See* Celerier & Matray, *supra* note 120.

[283] *See* James A. Berkovec, Glenn B. Canner, Stuart A. Gabriel, and Timothy H. Hannan, *Discrimination, Competition, and Loan Performance in FHA Mortgage Lending*, 80(2) Rev. Econ. & Stats. 241 (1998).

[284] *See* Robert Bartlett, Adair Morse, Richard Stanton, and Nancy Wallace, *Consumer-Lending Discrimination in the FinTech Era*, NBER Working Paper No. 25943 (June 2019), *available in* https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202016/Unbanked_October2016.pdf. Historical analysis has generally found less evidence of disparate treatment outside of mortgage markets, where government control played a role in sustaining discriminatory practices. *See* Richard L. Peterson, *An Investigation of Sex Discrimination in Commercial Banks' Direct Consumer Lending*, 12 Bell J. of Econ. 547 (1981).

[285] *See* Alexander W. Butler, Erik J. Mayer, and James P. Weston, *Racial Discrimination in the Auto Loan Market* at 19, www.SSRN.com (June 2020), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3301009.

[286] Id.

[287] *See* Kenneth P. Brevoort, *Credit Card Redlining Revisited*, 93 Rev. Econ. and Stats. 714 (2011).

[288] *See* Butler, et al., *supra* note 285, at 18. Although Butler, et al., found pricing disparities between White and minority customers controlling for credit score, they did not make an effort to control for investments in shopping or any of the other factors that are relevant to setting the interest rate on auto loans, such as including income, debt-to-income ratio, loan term, downpayment size, trade-in, vehicle type (model and whether new or used), and whether the prospective purchaser already has an existing preapproved financing offer from another financing source. *See* Report

Competition in consumer finance markets is not a panacea to address societal discrimination, the legacy of decades-long government-imposed racial segregation in housing markets, or formal and informal discrimination against disadvantaged groups in American society and the economy. Nor will greater competition in consumer finance markets remedy deeper societal challenges tied to lack of economic opportunity. As the NCCF observed, although valuable and important, programs designed to eliminate discrimination in consumer credit markets and to increase access by disadvantaged groups, largely treat the "symptoms" of these deeper underlying problems associated with discrimination and lack of economic opportunity.[289]

Thus, although competition in consumer finance markets cannot be expected to eliminate the historical legacy of discrimination or underlying problems of economic opportunity, competition can mitigate those effects and restrictions on competition can exacerbate the effects of those challenges. When the Bureau takes action to address disparate outcomes among various groups in financial markets, it should take care not to impose policies that inadvertently stifle competition or unnecessarily raise prices for all consumers, including those for whose benefit those actions were taken. When assessing disparities in outcomes among different groups of consumers the Bureau should be careful to account for all relevant considerations involving lending costs and risks. In addition to being alert at the outset to avoid unintended consequences, the Bureau should consider conducting retrospective reviews of major enforcement initiatives to determine whether its goals were met and to assess the overall intended and unintended consequences that resulted and the impact on consumer protection, access, competition, and innovation.

For example, there is some evidence that although the Bureau's equal credit enforcement initiative with respect to dealer-facilitated auto finance might have reduced racial disparities in loan terms, it also might have resulted in higher and more rigid price terms overall on average. According to a report in the *Wall Street Journal*, one strategy adopted by auto finance companies in response to the CFPB's initiative was to adopt policies that reduced discretion in dealer markups, which consumers can negotiate with dealers, in order to avoid accusations of disparate interest rate pricing.[290] Instead, finance companies simultaneously also "raised a less-

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Prepared by the Republican Staff of the United States House of Representatives, Unsafe at Any Bureaucracy: CFPB Junk Science and Indirect Auto Lending 38 (Nov. 24, 2015); *6 Factors that Affect Car Loan Rates*, www.idrivesafely.com, *available in* https://www.idrivesafely.com/defensive-driving/trending/6-factors-affect-car-loan-rates; Rod Looker, *5 Factors That Affect Your Auto Loan*, www.roadloans.com (Feb. 2, 2020), *available in* https://roadloans.com/blog/5-factors-that-affect-your-auto-loan. Dealers also often use promotional financing to move certain vehicles instead of direct price reductions.

[289] *See* NCCF Report, *supra* note 2, at 158-60.

[290] *See* AnnaMaria Andriotis and Gautham Nagesh, *Crackdown on Racial Bias Could Boost Drivers' Costs for Auto Loans*, Wall St. J. (Aug. 31, 2015), *available in* https://www.wsj.com/articles/crackdown-on-racial-bias-could-boost-drivers-costs-for-auto-loans-1441038864.

negotiable component of its rates," which the report characterized as "a move that could increase consumers' overall loan costs." Under the prior regime Black, Hispanic, and Asian borrowers were charged approximately 20-30 basis points higher rates than White borrowers, following the CFPB's enforcement actions (and responses to it), many consumers were paying rates that were "at least" 110 basis points higher. Thus, although the CFPB's enforcement actions might have reduced price differences among different racial groups, that greater uniformity might have come at the expense of higher and less-negotiable credit terms overall for the average car buyer, potentially including minorities who were the intended beneficiaries of the CFPB's enforcement actions.[291] One news report, of course, does not establish the presence of this offsetting effect, but it does illustrate the potential for unintended consequences resulting from government action and the usefulness of the Bureau conducting retrospective review of major enforcement initiatives to examine their overall effects on consumer protection, competition, and inclusion goals.

10.6 Paths Toward Increased Inclusion

The Taskforce believes that all policymakers, including Congress, the CFPB, the Department of the Treasury, and various financial regulatory agencies such as the Office of the Comptroller of the Currently (OCC), FDIC, National Credit Union Administration (NCUA), and others, should prioritize greater levels of financial inclusion and access to mainstream financial products. Consumer choice should be the guiding principle—those who seek, and qualify for, greater access to mainstream financial products should have access to those products as desired.

Leaving aside specific problems of discrimination and disparate treatment, the general problem of financial exclusion is one of inadequate choice and competition that interferes with the ability of certain consumers to access products and services in a marketplace free from bad practices by providers (such as fraud and unfairness) but also free from regulatory distortions that unfairly tilt the market and advantage some providers over others or some consumers over others. Laws, regulations, and other policies that deprive consumers of choices, especially those who already have the fewest choices available, should be viewed as presumptively unlikely to make those consumers better off. As noted above, decades of historical experience and economic analysis with usury ceilings has demonstrated repeatedly that those laws have often have harmed the class of consumers who the laws are purportedly intended to help. Although delivering less than purported in the way of benefit to lower-income consumers, however, usury ceilings, especially where tailored to particular product markets, and accompanying barriers to entry have often

[291] *See* Todd J. Zywicki, *The Dodd-Frank Act Five Years Later: Are We More Stable?*, 43 CAPCO J. of Fin. Transformation 62, 69 (May 2016).

been very beneficial to certain interest groups in segmenting markets and protecting them from competition.

As a result, the Taskforce urges policymakers to carefully scrutinize all laws and regulations to ensure that they *actually* will benefit *all* consumers, not merely the well-off, and that they promote competition and consumer choice, especially for those who otherwise have the fewest options. Policymakers should be especially skeptical of laws and regulations that control prices, especially those that interfere with risk-based pricing terms and that erect barriers to entry and competition. Regulations that restrict prices, choice, and competition in the name of consumer protection should be scrutinized under rigorous cost-benefit analysis to ensure that depriving consumers of choices and replacing voluntarily-determined prices and terms with politically-dictated prices and terms will benefit for consumers, especially the least well-off.

This section of the report provides an overview of some current laws and regulations that the Taskforce believes provide potential barriers to greater financial inclusion. This is not intended as an exclusive list but to point out some particular areas of concern and to provide guidance to the CFPB and other policymakers in examining existing regulations to ensure that they do not unduly interfere with efficient levels of financial inclusion. Second, the report goes beyond suggestions for review of current regulations that interfere with financial inclusion to a discussion of affirmative proposals that can further the goal of financial inclusion.

10.6.1 Removing Regulatory Barriers to Inclusion

We begin by identifying existing regulatory barriers to financial inclusion. For purposes of efficiency, we will not reiterate concern about usury ceilings in states that retain them in whole or in part. The Taskforce is unable to identify any tangible economic net benefit from the continuation of usury ceilings, especially for traditionally excluded consumers. Those states that continue to impose usury ceilings are urged to review their real-world effects and to modify them as appropriate.

Debit Card Interchange Price Controls

Section 1075 of the Dodd-Frank Act, entitled "Reasonable Fees and Rules for Payment Card Transactions," imposed price controls on the permissible prices that debit card issuers can charge for interchange fees on debit cards.[292] After a comprehensive view of the literature, the Taskforce has concluded that the enactment of Section 1075 and its implementing regulations

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[292] This provision of Dodd-Frank is sometimes referred to as the "Durbin Amendment," after its primary congressional sponsor, Senator Richard Durbin.

has produced higher bank fees, especially for lower-income consumers, and increased the number of Americans without a bank account, with minimal evidence that those increased bank fees have been offset by reductions in retail or other prices to consumers.

Payment card networks have two basic structures, what are referred to as either a three-party or four-party system.[293] A three-party system, such as American Express or Discover, is one in which the card issuer deals directly with both the consumer and the merchant. The network issues the card, processes the payment transfers, and operates the credit underwriting and processing function with respect to consumers. By contrast, in four-party system such as the Visa or MasterCard networks, consumers and merchants do not deal directly with the network. Instead, the relationship is intermediated through financial institutions—the consumer's bank that issues the card and services the consumer's account (called the "issuing bank" or "issuer") and the merchant's bank (called the "acquiring bank" or "acquirer"). The role of the network, is primarily limited to serving as a bridge between the issuing bank and the acquiring bank and providing the mechanisms and rules for which transactions take place.[294]

Payment card systems are a prominent example of what has come to be known as a "two-sided market."[295] Two-sided markets are ubiquitous in the economy, describing economic enterprises as diverse as shopping malls, internet search engines, dating services, social networking websites, app stores, and newspapers. The distinguishing characteristic of a two-sided market is that the consumer does not interact directly with the merchant, but instead transacts through an intermediary. The intermediary provides the platform through which this interaction can occur more easily. Thus, for example, the primary economic model of a newspaper is to connect advertisers with consumers through the platform of the newspaper, and the primary economic foundation of a search engine is largely the same. Each intermediary provides content that attracts consumers – articles in newspapers or search results for search engines—and such content imposes costs for the network that must be recovered from one of the participants in the platform, either the merchant or the consumer. As the Supreme Court wrote in *Ohio v. American Express*:

By providing these services to cardholders and merchants, credit-card companies bring these parties together, and therefore operate what economists call a "two-sided platform." As the name implies, a two-sided platform offers different products or services to two different groups

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[293] *See* Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, George Mason Law & Economics Research Paper No. 10-26 (June 2, 2010), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624002.

[294] For a more detailed explanation of the operation of payment card systems, *see* Zywicki, *supra* note 293, at 27-30.

[295] *See* Zywicki, *supra* note 293; *see also* Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAnd J. Econ. 645 (2006).

who both depend on the platform to intermediate between them."... For credit cards, that interaction is a transaction.... The key feature of transaction platforms is that they cannot make a sale to one side of the platform without simultaneously making a sale to the other. [296]

A logical corollary in the case of a two-sided market is that the costs of operating the system arise from the *joint* interaction of the cardholder and merchant through the network platform. [297] If a cardholder wants to use a form of payment that the merchant does not want to accept (such as Bitcoin, for example), then no cost is incurred. And if the merchant accepts a form of payment that the consumer does not want to use (say a check) then no cost is incurred. Costs are only incurred if *both* the consumer and merchant choose to interact through the platform. Thus, because these costs arise from the joint interaction, there is no "natural" way to allocate the costs associated with the platform supplying the transaction. [298]

More fundamental, the costs of operating the platform must come from merchants and consumers. [299] Costs that are not borne by consumers must be covered by merchants and vice-versa. Economic theory predicts that the owner of the platform will operate the platform, and allocate the costs accordingly, so as to maximize the value of the platform to its users. This requires the network to set the respective prices it charges for participants on each side of the market to use the platform. If the network sets the price too high for consumers, then they will be unwilling to use the network; similarly, if the network sets the price too high for merchants, they will not be willing to use the system.

For this result to occur, it is commonplace that one side of the platform will "subsidize" platform usage by the other side, typically taking the form of merchants subsidizing usage of the platform by consumers. [300] It also is not uncommon for there to be not only cross-subsidies *across* the two sides of the market (from merchants to consumers) but *among* the participants on one side of the market. In general, however, the costs of operating the two-sided market tend to fall on the

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[296] *Ohio v. American Express Co.*, 585 U.S. ___, slip op. at 2 (2018).

[297] See William F. Baxter, Bank Interchange of Transactional Paper: Legal and Economic Perspectives, 26 J. L. & Econ. 541 (1983).

[298] *See* Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

[299] *See* Zywicki, *supra* note 293, at 31-32.

[300] Thus, although advertisers draw little benefit from the news provided by a newspaper (other than in their employees' status as fellow readers), advertising expenditures cover much of the costs of providing that news function well beyond the costs of producing their particular advertisements. This subsidy is provided voluntarily by advertisers in order to persuade potential customers to read the newspaper and thereby to see the advertisements by generating higher circulation.

party that is the more "inelastic" demander of the platform's services, advertisers in the case of newspapers and merchants in the case of payment cards.[301]

The "interchange" fee in a network underlying use of payment devices like credit or debit cards is the fundamental price mechanism used within the four-party network system to allocate the costs among merchants and consumers.[302] The interchange fee is the element of the transaction that is remitted by the merchant's bank to the issuing bank when the transaction is made. The merchant discount fee also includes a fee the merchant pays its acquiring bank to process transactions as well as a small amount to the network itself. For credit cards, the merchant discount fee ranges from about 1.5 percent to 2.9 percent for swiped transactions and higher for keyed-in transactions.[303] The majority of the merchant discount is the interchange fee remitted to the issuing bank, which ranges from 1.4 percent to 3.4 percent and averages approximately 2.2 percent.[304] This interchange fee revenue, in turn, enables issuers to provide below-cost or even free credit card accounts to consumers, a variety of services such as anti-fraud protection and car rental insurance, as well as rewards such as cash-back or airline miles. Through the interchange fee, much of the cost of operating the payment card system traditionally has been borne by merchants, as in other two-sided platforms.

Getting the pricing right on consumer financial instruments is a crucial element of financial inclusion. For example, eliminating interest rate ceilings on credit cards also led to the elimination of annual fees, which had raised the costs for consumers of owning credit cards. In the case of bank accounts, the crucial development was the introduction of debit cards beginning around 2000, and their eventual supplanting of checks as a major transactional payment device by consumers. In 2000, debit cards transactions comprised about one-fifth of the transaction volume of checks and about half the volume of credit cards.[305] By 2006, however, debit cards passed credit cards to become the second most-popular noncash

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301 *See* Zywicki, *supra* note 293, at 33.

302 Three-party systems essentially have the equivalent of an interchange fee as well, it just is not a separate component of the merchant discount fee.

303 *See* Randy Hayashi, *What are the Average Credit Card Processing Fees that Merchants Pay?*, PaymentDepot.com (Jan. 24, 2020), *available in* https://paymentdepot.com/blog/average-credit-card-processing-fees/#:~:text=As%20mentioned%20earlier%2C%20merchants%20typically,transactions%20also%20have%20higher%20fees.

304 *See* Wayne Brough, *Would a Shift from Cards to Cash Really Help Retailers?*, RealClearPolicy.com (Sept. 1, 2020), *available in* https://www.realclearpolicy.com/articles/2020/09/01/would_a_shift_from_cards_to_cash_really_help_retailers_575902.html. The interchange fee is estimated at about 70%-90% of the total merchant discount fee. Hayashi, *supra* note 303.

305 *See* Board of Governors of the Federal Reserve System, The 2019 Federal Reserve Payments Study (Jan. 6, 2020), *available in* https://www.federalreserve.gov/paymentsystems/2019-December-The-Federal-Reserve-Payments-Study.htm.

transaction device in terms of transaction volume, and the next year debit cards passed checks as the most frequently-used noncash payment device.

This growth in debit card usage enabled a growth in access to bank accounts for many consumers. Traditionally, consumers bore most of the cost of maintaining a checking account by paying a monthly fee to defray the bank's costs of operating the account as well as bearing the cost of ordering checks. Although merchants benefited from the convenience and security provided by consumer use of checks instead of cash, especially for mail or larger transactions, consumers paid all of those costs. Merchants received payment at "par" (i.e., 100 cents on the dollar) and consumers paid the bulk of the costs for this payment device.

The introduction of debit cards fundamentally transformed this economic relationship. Like credit card issuers, debit card issuers charge an interchange fee when consumers use their cards. As a result, banks were able to defray much of the cost of operating the debit card network through interchange fee revenues. With a few debit card transactions per month, many consumers could cover the bank's costs of providing bank account services. Banks used to pass on these benefits to consumers in the form of free checking programs. The result was potentially profound for consumers, especially for lower-income consumers and those previously not participating in the mainstream financial system.

Before 2001, it is estimated that fewer than 10 percent of bank accounts offered free checking.[306] According to a survey report in 2001, the number of free checking accounts had risen to "an all time high of 7.5 percent, up from 7.1 percent" the year before.[307] By 2009, 76 percent of bank accounts were free checking accounts, according to one widely-cited estimate.[308] By dramatically expanding access to free checking and eliminating monthly maintenance fees, the introduction and rapid adoption of debit cards dramatically expanded financial inclusion for many consumers who traditionally could not afford a bank account.

Section 1075 of the Dodd-Frank Act, however, intervened to provide that interchange transaction fees for debit transactions shall be "reasonable and proportional" to the cost incurred by the issuer with respect to a particular transaction, including costs for authorization,

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[306] *See* Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Price Controls on Payment Card Interchange Fees: The U.S. Experience* 5, ICLE Financial Regulatory Research Program White Paper 2014-2 (2014), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080..

[307] *See* Laura Bruce, *Free Checking Accounts*, Bankrate.com (Oct. 15, 2001), *available in* https://www.bankrate.com/finance/checking/free-checking-accounts.aspx. The number of institutions offering free checking plans doubled between 2001-2006. *See* United States Government Accountability Office, Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts 15 (Jan. 2008),.

[308] Zywicki, et al., *Price Controls*, *supra* note 306, at 5.

clearance, or settlement, but not other costs associated with providing debit cards to consumers, such the costs associated with issuing cards, operating bank branches, advertising and account acquisition, ATMs, other teller services, or general customer support operations. (The final fee also could include reimbursement for costs related to fraud prevention.) By its terms, Section 1075 applies only to financial institutions with assets of $10 billion or more, which account for approximately two-thirds of all debit card transactions annually.[309]

In October 2011 the Federal Reserve's regulations governing interchange fees became effective. The consequences for covered banks was dramatic—interchange fees were slashed from approximately $0.51 per transaction (an average of signature and PIN debit combined) to a maximum $0.24 per transaction where it has remained more or less since that time.[310] The direct effect on covered banks was initially estimated as a reduction in annual revenue of approximately $4.1-$6.5 billion[311] but has increased as time has passed and the volume of debit card transactions in the economy has continued to grow. According to one recent estimate, the annual lost interchange revenue to banks as a result of Section 1075 has grown from an estimated $8.9 billion in 2012 to $14 billion in 2019 and the total estimated lost interchange revenue as $90.9 billion since its implementation.[312]

As would be predicted by the basic theory of two-sided markets, financial institutions have responded to this revenue loss from merchants by passing on more of the costs of operating the platform to consumers. Of particular concern to the Taskforce, the manner in which those losses have been recovered from consumers has fallen particularly heavily on lower-income consumers and has erected a significant barrier to greater financial inclusion. In this sense, the harmful consequences of Section 1075's price controls are consistent with earlier experiences with

309 Board of Governors fo the Federal Reserve System, Regulation II (Debit Card Interchange Fees and Routing) (July 18, 2019), *available in* https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm

310 *See* Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Unreasonable and Disproportionate: How the Durbin Amendment harms Poorer Americans and Small Businesses,* International Center for Law and Economics (Apr. 25, 2017); *see also* Board of Governors fo the Federal Reserve System, Regulation II (Debit Card Interchange Fees and Routing) (July 18, 2019), *available in* https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm.

311 *See* Benjamin S. Kay, Mark D. Manuszak, and Cindy M. Vojtech, *Competition and Complementarities in Retail Banking: Evidence form Debit Card Interchange Regulation*, 34 J. Fin. Intermediation 91, 92 (2018); *see also* Vladimir Mukharlyamov and Natasha Sarin, *Price Regulation in Two-Sided Markets: Empirical Evidence from Debit Cards* (Dec. 2019) (estimating $5.5 billion annual revenue loss to banks from interchange fee reductions); Bradley G. Hubbard, *The Durbin Amendment, Two-Sided Markets, and Wealth Transfers: An Examination of Unintended Consequences Three Years Later* 20 (Working Paper, May 20, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2285105 (estimating annual revenue loss of $6.6 billion to $8 billion from Durbin Amendment).

312 *See* Electronic Payments Coalition, EPC Analysis of the Cost of the Durbin Amendment (July 2020).

similar price control programs such as usury ceilings, which typically disadvantage lower-income consumers relative to wealthier ones.[313]

Banks and credit unions covered by Section 1075 have responded to the law's effects in a number of ways. As noted, between 2001 and 2009 the percentage of bank accounts that were free accounts had increased by an order of magnitude, from 7.5 percent to 76 percent.[314] By 2013, that figure had fallen in half, to 38 percent.[315] At the same time, monthly maintenance fees for non-free checking accounts rose substantially, doubling in amount according to some estimates.[316] Moreover, maintenance fees did not creep up gradually over time—instead, the doubling occurred discretely in the second half of 2010, immediately after the Dodd-Frank Act, including Section 1075, was passed, and then rose again slightly in 2011 when the regulations implementing Section 1075 were finalized.[317] The percentage of bank accounts subject to free checking has remained near this level since.[318]

A study by Mukharlyamov and Sarin using a different database identified an even larger reduction in access to free checking accounts, finding that the share of free basic checking accounts fell from 61 percent to 28 percent as a result of Section 1075.[319] Similarly, they estimated that if Section 1075 had not taken effect, 65 percent of bank accounts would have been free checking accounts, but that the actual number was 35 percentage points lower (30 percent).[320]

Economic studies have confirmed that much, if not most, of this revenue loss was recovered by affected banks through increased bank fees. Kay, et al., estimated that increases in deposit fees offset more than 90 percent of the lost interchange fee income.[321] Mukharlyamov and Sarin estimated that issuers lost approximately $5.5 billion in reduced interchange fee income

[313] Zywicki, *Economics of Credit Cards, supra* note 32, at 158-59.

[314] *See* Zywicki, et al., *Price Controls, supra* note 306, at 6.

[315] Zywicki, et al., *Price Controls, supra* note 306, at 6.

[316] Zywicki, et al., *Price Controls, supra* note 306, at 7.

[317] Zywicki, et al., *Unreasonable and Disproportionate, supra* note 310, at 12.

[318] Zywicki, et al., *Unreasonable and Disproportionate, supra* note 310, at 11.

[319] Mukharlyamov and Sarin, *supra* note 311, at 4.

[320] Mark D. Manuszak and Krzysztof Wozniak, *The Impact of Price Controls in Two-Sided Markets: Evidence from US Debit Card Interchange Fee Regulation*, Federal Reserve Board, Finance and Economics Discussion Series 2017-074 (2017).

[321] Kay, et al. *supra* note 311, at 99 (noting that banks covered by § 1075 increased bank fees by about $4 billion total, offsetting a revenue reduction of approximately $4.1 billion in reduced interchange fees).

annually, of which they recouped about $2.3 billion in higher bank fees, or approximately 42 percent of lost revenue.[322]

But the loss of access to free checking and exposure to higher bank fees was not randomly distributed among bank customers. The primary way in which banks rationed access to free checking following Section 1075's passage was by increasing the average minimum balance needed for a customer to be eligible for free checking.[323] In 1999, consumers were required to hold an average balance of $562 in the typical bank account in order to be eligible for free checking. By 2008, however, that figure had fallen to $109. By 2012, that figure had soared to $723 and has remained around that level since.[324] Needless to say, higher-income customers are much more likely to be able to meet or even disregard these higher minimum balance requirements than lower-income consumers. Manuszak and Wozniak estimated that as a result of Section 1075, the average minimum balance necessary to quality for noninterest free checking accounts increased by over $400 and by nearly $1,700 for interest-bearing checking accounts.[325]

Mukharlyamov and Sarin concluded, "These higher fees are disproportionately borne by low-income consumers whose account balances did not meet the monthly minimum required to waive these fees."[326] Overall, they found "[O]ver 70 percent of consumers in the lowest income quintile (annual household income of $22,500 or less) bear higher account fees, since they fall below the average post-Durbin account minimum required to avoid a monthly maintenance fee

322 Mukharlyamov and Sarin, *supra* note 311, at 2-4. They concluded that average checking account fees increased from $3.07 to $5.92 per month. *Id.* at 4.

323 Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 310, at 11.

324 Mukharlyamov and Sarin estimated a 21 percent increasd in the monthly minimum needed to be eligible for free checking and to avoid having to pay monthly fees.

325 Manuszak and Wozniak, *supra* note 320, at 5. Two recent surveys by consumer finance websites of bank account terms of the largest banks also illustrate the high cost to those who no longer qualify for free checking accounts. A survey by Moneyrates.com reported an average monthly maintenance fee of $14.39 per month ($172.68 per year) on the accounts it surveyed. *See* Richard Barrington, *How Much are Bank Fees—The Latest MoneyRates Update* (Aug. 20, 2020), *available in* https://www.money-rates.com/research-center/bank-fees/. A study by another website reported an average monthly fee on the accounts reviewed had an average monthly fee of $9.60 per month ($115.20 per year) and the minimum balance necessary to waive the fee $1,010. *See* Theresa Kim, *Checking Account Fee Comparison at Top U.S. Banks*, Mybanktracker.com (Jul. 23, 2020), *available in* https://www.mybanktracker.com/news/checking-account-fee-comparison-top-10-us-banks. This survey includes one Internet bank that reports a monthly fee of zero, with no minimum balance required. If that bank is excluded, the average monthly fee would be $10.61.

326 Mukharlyamov and Sarin, *supra* note 311, at 4. Banks may also wave monthly fees or deposit minimums where the consumer uses another bank product, such as auto loans or home equity loans. In general, it would be expected that higher-income customers would be more likely to seek further financial services of that type from the bank than lower-income individuals.

($1,400). In contrast, only 5 percent of consumers in the highest income quintile (household income of $157,000 or more) keep balances falling below this threshold."[327]

These higher bank fees for lower-income consumers appear to have pushed many of them out of bank accounts entirely and into the ranks of the unbanked. According to the FDIC, between 2009-2011 the number of unbanked consumers rose by one million and the number of underbanked consumers rose by three million, forcing them to rely on alternatives that ultimately are more expensive, including money orders, prepaid cards, and check cashers.[328] As discussed above, the most frequently cited reasons that unbanked consumers have provided in recent years for not having a bank account is that minimum balance requirements and account fees are too high, and the figure has risen steadily in the decade since the Dodd-Frank Act was enacted.[329] Moreover, unbanked consumers who previously had kept a bank account but no longer did were much more likely to cite high and unpredictable fees as a reason for not having a bank account. Mukharlyamov and Sarin found an 81 percent increase in the percentage of unbanked consumers stating that high account fees as their main reason for not having a bank account after Section 1075 was enacted.[330] Further, they found that residents in states that were most impacted by Section 1075 (those with the highest share of deposits at banks above the $10 billion threshold) were most likely to attribute their unbanked status post-Section 1075 to high fees.[331] The growth in the recently unbanked was also highest in states with more affected banks, where the increase in account fees is most pronounced.

Finally, banks covered by Section 1075 price controls also recouped interchange fee losses by eliminating or cutting card rewards programs on debit cards.[332] According to one estimate, rewards averaged approximately 5 cents per transaction prior to the passage of the Dodd-Frank Act, an amount which was cut to average of about 2 cents per transaction after the Dodd-Frank Act's enactment.[333] Credit card interchange fees and rewards, by contrast, remained unaffected. As a result, higher-income consumers avoided Section 1075's sting by increasing their use of

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327 *Id.* at 30.

328 *See* Zywicki, et al., *Price Controls, Price Controls*, *supra* note 306.

329 *See* discussion at *supra* note 137 and accompanying text.

330 Mukharlyamov and Sarin, *supra* note 311, at 30.

331 Id.

332 *See* Darryl E. Getter, *Regulation of Debit Interchange Fees* at 8, Congressional Research Service (May 16, 2017); *see also* Electronic Payments Coalition, Out of Balance: How the Durbin Amendment has Failed to Meet Its Promises 7 (Dec. 2018). Eliminating rewards, such as cash-back on purchases, is functionally equivalent to a price increase.

333 Kay, et al., *supra* note 311, at 99.

credit cards for transactional purposes in place of debit cards.[334] Lower-income consumers, by contrast, are less likely to have credit cards than high-income consumers, and as a result replaced their reduced debit usage with increased use of cash and checks.[335] According to a discussion paper by the Federal Reserve Bank of Philadelphia Consumer Finance Institute, this shift from debit card usage to credit card usage among consumers was driven by two factors: "regulatory changes in the debit space that limited interchange, making debit rewards less financially viable for depository institutions and a change in preferences by both card issuers and consumers for more and richer rewards as incentives for using a particular form of payment."[336] Ironically, therefore, the net effect of Section 1075's impact has been to reduce or eliminate rewards for those who use debit cards while preserving them for higher income consumers who use credit cards.[337]

Nevertheless, some commentators have argued that lower-income consumers benefit from interchange fee price controls because of the potential that the costs of interchange fees are passed through by merchants and are thus captured in retail prices that are paid by both cash and credit shoppers. One study often cited, for example, estimates that low-income households pay on average $21 per year in higher prices as a result of credit card interchange fees and card rewards and argues that price controls on interchange fees would increase consumer welfare.[338] The argument rests on a number of questionable assumptions, most notably that retailers would pass-through 100 percent of their cost-savings to consumers whereas banks are implicitly assumed to pass through none of their lost revenues to their customers.[339]

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334 *See* Zywicki, *et al., Price Controls, Price Controls, supra* note 306, at 18-22; *see also* Vladimir Mukharylyamov and Natasha Sarin, *The Impact of the Durbin Amendment on Banks, Merchants, and Consumers*, Institute for Law and Economics Research Paper No. 19-06, at 34-35 (Jan. 2019); Tom Ankana, *Consumer Payment Prefernces and the Impact of Technology and Regulation: Insights from the Via Payment Panel Study,* Federal Reserve Bank of Philadelphia Consumer Finance Institute Discussion Paper DP 19-01 (Feb. 2019).

335 *See* Sergei Koulayev, Marc Rysman, Scott Schuh, and Joanna Stavins, *Explaining Adoption and Use of Payment Instruments by US Consumers,* 47 Rand J. of Econ. 293 (2016). Kloulayev, et al., also note the same trends associated with higher and lower education levels.

336 Ankana, *supra* note 334, at 11.

337 The regressive effects of interchange fee price controls and the impact on payment card rewards mirrors the experience with interchange fee price controls in Australia, where rewards for ordinary cardholders decreased and the generosity of rewards programs for higher-income consumers increased. *See* Iris Chan, Sophia Chong, and Stephen Mitchell, *The Personal Credit Card Market in Australia: Pricing Over the Past Decade,* Reserve Bank of Australia Bulletin 55 (March Quarter 2012).

338 *See* Scott Schuh, Oz Shy, and Joanna Stavins, *Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations*, Fed. Res. Bank Boston Research Department Public Policy Discussion Paper No. 10-03 (2010); *see also* Aaron Klein, *How Credit Card Companies Reward the Rich and Punish the Rest of Us*, Los Angeles times (Dec. 20, 2019), *available in* https://www.latimes.com/opinion/story/2019-12-20/opinion-how-credit-card-companies-reward-the-rich-and-punish-the-rest-of-us.

339 The study examines credit cards but the analysis is equally applicable to debit cards.

It turns out that pass-through argument rests on some questionable theoretical assumptions and empirical generalizations that have been subsequently found to be invalid.[340] For example, the authors assumed a 100 percent pass-through rate—i.e., that the *entire* savings from interchange fee reduction would be passed through by retail merchants to consumers. This was a completely unrealistic assumption based on existing knowledge at the time, and subsequent research has confirmed that merchant pass-through of savings is much less than 100 percent.

The most precise estimate of pass-through of savings is provided by Mukharlyamov and Sarin, who estimated that merchants passed through "at most" 28 percent of their debit card savings to consumers, while banks had passed through 42 percent of their interchange fee revenue losses to consumers (with most of those losses being passed on to lower-income consumers who pay higher bank fees). They estimate that the net result of this was a $4 billion transfer to merchants, of which $3.2 billion came directly from banks and $0.8 billion from consumers, who paid $2.3 billion in higher checking fees but received only $1.5 billion in lower retail prices.

Using surveys of merchants a few years after Section 1075 became effective, Wang, Schwartz, and Mitchell, found that although some merchants received reductions in the merchant discount rate they paid, others actually saw their debit card acceptance costs increase.[341] They found an asymmetric response—merchants who saw their prices increase usually passed those increased costs onto their customers while very few of those who saw their debit costs decrease passed those costs onto customers. This suggests that there was very little pass-through of savings by merchants—certainly far less than 100 percent—and that if there was any substantial pass-through at all it was greatly delayed.

Most obvious, and most important, while Schuh, et al., assume full pass-through by merchants of lower card acceptance costs, they implicitly assume no pass-through of revenue losses by banks through reduced access to free checking, higher required minimum balances, and higher bank fees, costs which fall dramatically more heavily on lower-income. Although the researchers estimate that under their assumptions, lower-income consumers *could* save as much as $21 per year in lower retail costs from interchange fee price controls, this small cost is dramatically

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340 See Ian Lee, Geoffrey A. Manne, Julian Morris, and Todd J. Zywicki, Credit Where It's Due: How Payment Cards Benefit Canadian Merchants and Consumers, and How Regulation Can Harm Them, MacDonald-Laurier Institute 25-33 ((Oct. 2013).

341 Zhu Wang, Scarlett Schwartz, and Neil Mitchell, *The Impact of the Durbin Amendment on Merchants: A Survey Study,* 100(3) Econ. Q. 183 (2014) (3rd Quarter). Some merchants saw their acceptance costs increase because prior to Dodd-Frank's price controls some merchants, especially smaller merchants, had received discounts on acceptance costs. But the imposition of price ceilings also effectively created a price floor, leading some merchants to pay higher fees than before.

outweighed by higher bank fees that are estimated in the range of $115 to $172 per year[342] That increase in fees resulted in the loss of bank access for many consumers.

Overall, the evidence indicates that operation of Section 1075 of the Dodd-Frank Act has had a significant adverse impact on financial inclusion, especially for lower-income consumers. Access to free checking has dropped dramatically, and bank fees and required minimum balances have risen substantially. In turn, these higher fees have driven many lower-income consumers out of the mainstream financial system and pushed them toward greater reliance on alternative financial services providers such as check cashers and prepaid cards. In exchange there is little evidence of substantial pass-through of merchant savings to consumers, much less savings that would offset the dramatic increase in bank fees that have resulted, especially for lower-income consumers.

Credit CARD Act and Federal Reserve Regulations on Credit Card Terms

Recent laws and regulations have also impacted consumer access to credit cards. In 2009, Congress enacted the CARD Act.[343] The law required new disclosures by credit card issuers. It also imposed new restrictions on contractual terms between consumers and issuers regarding the terms and amount of late and over-limit fees as well as the circumstances under which issuers can adjust interest rates in response to changes in the consumers' risk profile. Although passed in 2009, the CARD Act largely codified similar Federal Reserve regulations proposed in May 2008 and adopted in December 2008.[344]

Subsequent research has found that the CARD Act had the intended effect of reducing some costs for some consumers with respect to the terms that were limited by the law.[345] Nevertheless, the CARD Act also had substantial adverse unintended consequences for many other consumers in terms of card access, credit availability, and other prices, especially for non-prime borrowers.

342 The author's analysis applies to credit cards not debit cards but, oddly, they assume that the annual fee on credit cards would remain the same after the imposition of interchange fee price controls. Experience in Australia and elsewhere reveals this assumption to be completely unfounded. *See* Chan, et al., *supra* note 337337.

343 Pub. L. No. 111-24, 23 Stat. 1734 (2009).

344 74 Fed. Reg. 5498, "Unfair or Deceptive Acts or Practices" (Jan. 29, 2009). Although the rule was finalized on December 18, 2008 its effective date was set as July 1, 2010. In the meantime, Congress passed the CARD Act, so the Federal Reserve rule never took effect before being supplanted by legislation. Even prior to the Federal Reserve regulations, however, an early draft of the legislation was introduced in Congress in February 2008 as the "Credit Card holders' Bill of Rights Act of 2008" (H.R. 5244) contained substantively similar terms.

345 For a summary of these effects *see* Bureau of Consumer Financial Protection, The Consumer Credit Card Market (Aug. 2019).

At the time the Federal Reserve rules were announced and later when the CARD Act was enacted, industry experts predicted that the rules would likely reduce costs for some consumers, especially those who make late payments, fail to make minimum payments, or exceed credit limits. They also warned that the costs of the rules likely would be passed on to other consumers in the form of higher prices and lower credit lines. In particular, concern was expressed that the costs would fall most heavily on higher-risk and lower-income consumers in the form of higher interest rates and less access to credit cards.

For example, in the announcement of the Federal Reserve's rule in December 2008, Federal Reserve Governor Randall S. Kroszner observed, "Although consumers might see some costs decline as new business models emerge, consumer[s] might see other costs increase."[346] Governor Kroszner also observed that issuers "might need to strengthen upfront underwriting efforts in the process," i.e., by restricting credit card access for higher-risk borrowers.

In his 2010 shareholder letter, JPMorgan Chase CEO Jamie Dimon predicted that the consequences of the CARD Act would be to reduce access and increase prices for its customers, especially for higher-risk and less-affluent customers.[347] He wrote, "However, because the new law makes it harder to raise rates on customers who have become far riskier ... we and other competitors have had to make some fairly drastic changes in the business ..." He noted that in response to the CARD Act, Chase had "substantially reduced very low introductory or promotion balance transfers," canceled the credit cards of those with dormant accounts, and "reduced limits on credit lines" by $1.4 trillion, from a peak of $4.7 trillion to $3.3 trillion. Finally, he observed, "In the future, we no longer will be offering credit cards to approximately 15% of the customers to whom we currently offer them. This is mostly because we deem them too risky in light of new regulations restricting our ability to make adjustments over time as the client's risk profile changes." Moreover, at the same time Chase was restricting access and credit lines to riskier borrowers because of its inability to price risk effectively, Dimon announced the bank's introduction of the Chase Sapphire card, which "was developed from the ground up to address the needs of affluent consumers, with premium rewards and exceptional service."

Some empirical studies of overall effects of the Federal Reserve rules and the CARD Act have been largely as predicted. Some late-payers, non-payers, and those who exceed their credit limits have reaped cost savings from the CARD Act's restrictions on fees and interest rate adjustments. But compelling empirical evidence indicates that the costs of the CARD Act have

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346 Statement of Governor Randall S. Kroszner (Dec. 18, 2008), *available in* https://www.federalreserve.gov/newsevents/pressreleases/kroszner20081218a.htm.

347 *See* Jamie Dimon, Chairman and Chief Executive Officer, 2010 JPMorgan Chase Shareholder Letter 11 (Mar. 26, 2010), *available in* https://getoutofdebt.org/wp-content/uploads/chaseshareholders.pdf.

been borne predominantly by other lower-income and higher-risk consumers who have found it more difficult to obtain a credit card, received lower credit lines, and paid higher interest rates and other costs. Of particular note, economic studies indicate those who have lost access to credit cards or had their credit lines reduced as a result of federal law and regulations have substituted financial providers that charge higher prices and interest rates for credit card issuers. Higher-income consumers and lower-risk borrowers, by contrast, have seen few adverse consequences from the CARD Act.

A recent study by researchers at the Philadelphia Federal Reserve Bank and New York University analyzed the effects of the Federal Reserve's 2008 regulations and the CARD Act separately.[348] They found that the 2008 regulations and the CARD Act had similar and separate effects on consumers.[349] Both the Federal Reserve rules and the CARD Act had adverse effects on credit availability for non-prime borrowers while there was no corresponding reduction in availability to prime consumers. In fact, there were significant market effects of reductions in credit availability to non-prime consumers at each stage of the progression from the initial proposal of the Federal Reserve regulations, the passage of the CARD Act, and enactment of the final implementing regulations.

The finding that the CARD Act resulted in reduced credit access for subprime borrowers is consistent with other studies that found that the CARD Act resulted in higher prices, more restrictive credit availability, or both, especially when combined with impact of the Federal Reserve's earlier regulations. For example, Han, Keys, and Li analyzed credit card mail solicitations before and after the CARD Act's enactment and found that nonprime households were 6.6 percentage points less likely to receive an offer after implementation of the act, and that the offers they received had lower credit limits and higher interest rates than before.[350]

In some instances, researchers concluded that the Federal Reserve's regulations caused the primary impact, rather than the CARD Act itself. For example, Jambulapati and Stavins found that issuers closed credit card accounts around the period of the enactment of the Federal

[348] Yiwei Dou, Julapa Jagtiani, Joshua Ronen, & Raman Quinn Maingi, *The Credit Card Act and Consumer Debt Structure*, Fed. Res. Bank of Phila. Research Dept. Working Paper, WP 20-32 (Aug. 2020).

[349] Although the Federal Reserve regulations did not become effective until 2010, the authors sought to determine whether credit card issuers adjusted their underwriting criteria following the finalization of the Regulations in anticipation of their effect.

[350] *See* Song Han, Benjamin J. Keys, & Geng Li, *Unsecured Credit Supply, Credit Cycles, and Regulation*, 31 Review of Fin. Studies 1185 (2018).

Reserve's rules but that in response to the CARD Act, issuers reduced available credit limits.[351] Larry Santucci compared the terms of credit card accounts opened in 2005, the period predating both the Federal Reserve regulations and the CARD Act, with 2011, after the CARD Act had become effective.[352] He found that during that period the median initial credit limit fell by 60 percent (from $5000 to $2000) and that credit limit increases were lower as well. Moreover, "these effects were especially pronounced among the riskiest 25 percent of accounts opened in 2011."[353] With respect to this group, he found that the median initial credit limit fell 66.7 percent to $500 and the median limit increase amount fell by at least 25 percent.[354]

Lux and Greene found a variety of developments in the credit card market that are likely attributable to the impact of the CARD Act.[355] They found, for example, that consumers with lower-credit scores comprised a smaller percentage of new credit card account originations in 2015 and that they were a smaller percentage of the revolving credit card market in 2015 than in 2007. A 2014 research report by Goldman Sachs also concluded that "lower-income borrowers [were] most affected" by the CARD Act and that although interest rates rose for all cardholders, interest rates for higher risk consumers rose substantially more than for prime consumers.[356] In addition, credit extensions to subprime borrowers plummeted in the period after the CARD Act while credit offers to "super-prime" borrowers increased.

Elliehausen and Hannon also examined the combined effects on consumers from the Federal Reserve regulations and the CARD Act together with the general effects caused by the financial crisis and subsequent recession during that period.[357] They found a general decline in credit card accounts at the beginning of this period, which they attributed largely to the effects of the financial crisis and recession, which led to deleveraging by consumers. But they also found a decrease in the *relative* number of credit card accounts held by non-prime borrowers relative to prime borrowers during the period of the implementation of the CARD Act: Where prime

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351 *See* Vikram Jambulapati & Joanna Stavins, *Credit Card Act of 2009: What Did Banks Do?*, 46 J. Banking & Finance 21 (2014). By contrast, they found some evidence that higher-income and more educated consumers may have experienced an increase in credit lines during this same period.

352 Larry Santucci, A Tale of Two Vintages: Credit Limit Management Before and After the CARD Act and Great Recession, Fed. Reserve Bank Phila. Discussion Paper 15-01 (Feb. 2015).

353 *Id.* at 4.

354 *Id.* at 4.

355 Marshall Lux and Robert Greene, *Out of Reach: Regressive Trends in Credit Card Access,* Harvard Kennedy School Mossavar-Rahmani Center for Business and Government, M-RCBG Associate Working Paper Series No. 54 (Apr. 2016).

356 Goldman Sachs, Who Pays for Bank Regulation? 7 (June 2014).

357 *See* Elliehausen and Hannon, *supra* note 61.

consumers suffered little adverse effect from the CARD Act, subprime consumers experienced a reduction in access to credit-card credit. Elliehausen and Hannon concluded, "Specifically, we found that the number of credit card accounts declined significantly during the CARD Act implementation period for both nonprime and prime consumers, but that the decline for nonprime consumers was more than that for prime consumers. We then showed that credit card account declined further for nonprime but not prime consumers after the CARD Act became effective. Part of the declines observed can be attributed to deleveraging related to the recession, but the larger further declines for nonprime customers likely were caused by the CARD Act's restrictions on risk management practices, which adversely affected higher risk consumers."[358]

Moreover, Elliehausen and Hannon found that many of those non-prime consumers that suffered loss of access to credit cards shifted their borrowing to traditional installment lenders, which typically offered higher costs and less flexibility than credit cards. Of course, for many non-prime consumers this option was only available in states where prevailing regulations (including usury ceilings) afforded consumers the option of installment loans. In states with restrictive laws, consumers were unable to avail themselves of those products. It is unclear where the latter individuals turned to meet their credit needs (such as payday loans, bank overdraft protection, or some other source). Elliehausen and Hannon observed, "These results suggest that the reduction in bank card availability may have prompted consumers to substitute consumer finance credit for bank card credit in states in which consumer finance credit is available."[359]

Other research is consistent with these findings that the CARD Act reduced access and increased the costs of credit cards for marginal consumers. The CFPB's 2013 CARD Act Report, for example, identified a dramatic decrease in credit availability during the period of the CARD Act's passage and implementation.[360] Overall, the CFPB concluded that the percentage of households with credit cards declined by five percentage points during that period and that, overall, total credit lines available on all cards fell by $200 billion, with the greatest reductions in available credit lines for subprime borrowers. The CFPB also concluded, "Mail volume by credit card issuers soliciting new accounts fell much more dramatically for subprime borrowers than for all consumers," that "the approval rate for new cards for subprime borrowers fell much more than for other card segments, and "[o]riginations of new subprime accounts declined

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358 Elliehausen and Hannon, *supra* note 61.

359 Elliehausen and Hannon, *supra* note 61.

360 Consumer Financial Protection Bureau, CARD Act Report: A Review of the Impact of the CARD Act on the Consumer Credit Market (Oct 2013),

sharply."[361] On average, the CFPB estimated a 230 basis point increase in the purchase APR on credit cards and increases in cash advance fees.

A study by the Pew Trust soon after the enactment of the CARD Act found that while the newly-regulated fees (such as over-the-limit fees) declined as a result of the law, other fees increased.[362] They found that the average annual fee and average interest rates charged on credit cards increased, especially in the period after the issuance of the Federal Reserve regulations. Pew also found that other fees not regulated by the CARD Act, such as cash-advance fees and other fees and penalty interest rates, also increased.

Overall, the period surrounding the enactment and implementation of the CARD Act was associated with a substantial decline in access to credit cards by higher-risk borrowers. By contrast, higher-income borrowers suffered little disruption in their access to credit cards. According to research by Federal Reserve Board economists Glenn Canner and Gregory Elliehausen, the percentage of households in the lowest quintile of credit scores with credit cards fell 11 percentage points, from 65 percent in 2008 to 54 percent in 2010.[363] By contrast, during that same period, card holding by households in the highest quintile of risk scores fell only 1 percentage point, from 91 percent to 90 percent of households.

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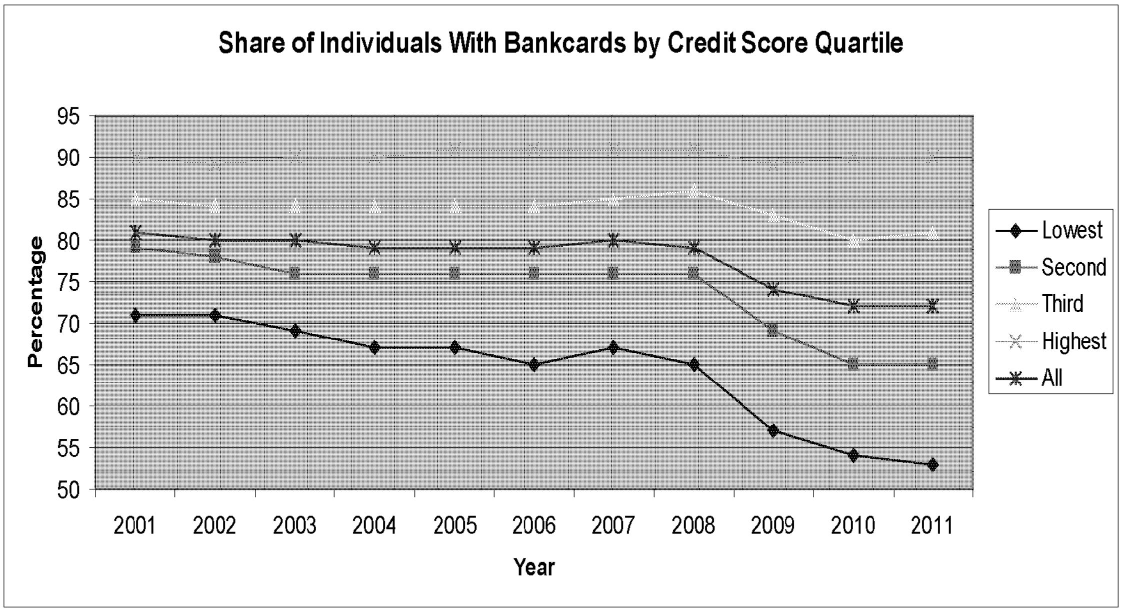
[361] Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki, An Assessment of Behavioral Law and Economics Contentions and What We Know Empirically about Credit Card Use by Consumers, 22 S. Ct. Econ. Rev. 1, 48 (2014).

[362] See Nick Bourke and Ardie Hollfield, Two Steps Forward: After the Credit Card Act, Credit Cards Are Safer and More Transparent—But Challenges Remain, Report of the Pew Health Group, Pew Trusts (July 2010).

[363] Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards,* Fed. Res. Bulletin 10, Table 2 (2013).

FIGURE 10-2: CREDIT CARD OWNERSHIP BY CREDIT SCORE QUINTILE



Source: Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 Fed. Res. Bulletin 10, Table 2 (2013).

Other studies have concluded that by constraining the ability of parties to adjust the price and other terms of the contract, the CARD Act reduced. Analyzing the competitive effects of the CARD Act, Dou, Li, and Rosen found "a significant decline in the responsiveness of an issuer to competitors' changes in interest rates, but not in other credit terms that are unrelated to repricing."[364] Moreover, they found that this reduction in response of competitors was asymmetrical—reduced competitive effects were found only with respect to *decreases* in competitors' interest rates but not for *increases*. Further, they found that the adverse effect on competition was greatest with respect to subprime borrowers. They also found increases in price dispersion and markups, further evidence of reduced competitive effects

In a theoretical analysis, Hong, Hunt, and Serfes, predicted that the CARD Act's limits on price adjustments would reduce competition for customers and result in higher up-front interest rates, on average, for all borrowers. The end result would be to "increase deadweight losses and reduce ex ante consumer surplus." Although Hong, et al., do not provide empirical analysis of their model, their prediction is consistent with the CFPB's findings that average interest rates on

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[364] Yiwei Dou, Geng Li, and Joshua Rosen, *Does Price Regulation Affect Competition? Evidence from Credit Card Solicitations* at 27, Federal Reserve Board Finance and Economics Discussion Series 2019-018 (Feb. 2019), *available in* https://www.federalreserve.gov/econres/feds/files/2019018pap.pdf.

credit cards increased following the promulgation of the Federal Reserve's regulations and the enactment of the CARD Act.[365]

Three studies have purported to find minimal adverse effects on consumers from enactment of the CARD Act.[366] Each of them examined changes in credit card access and pricing "before" and "after" the CARD Act's passage. Unfortunately, all the studies take as their "before" period the time immediately preceding the CARD Act's effective date; as a result, they fail to account for any adjustments made by credit card issuers in response to the Federal Reserve's 2008 regulations.[367] This failure is crucial, however, because those studies that have considered the impact of the Federal Reserve's regulations on the credit card market consistently have found important and significant independent effects from those regulations. As a result, the "before" period identified by these researchers is not the "before" period, as it includes adjustments made by card issuers in response to the Federal Reserve's regulations.[368]

Overall, it appears that the CARD Act reduced costs for those who overdraw their credit limits, late payers, and others directly benefited by the CARD Act's terms. However, these benefits came at significant costs to many other consumers through higher interest rates, increases in other unregulated fees, reductions in credit lines, and reduced credit card availability. As predicted by Governor Kroszner at the time of the Federal Reserve regulations and later by Jamie Dimon when the CARD Act became effective, the brunt of these market adjustments felt most heavily on higher-risk borrowers relative to lower-risk borrowers. As noted by Elliehausen and Hannon, many higher-risk borrowers who lost access to credit cards appeared to switch to

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[365] *See* discussion at *supra* note 361 and accompanying text.

[366] See Scott Nelson, Private Information and Price Regulation in the US Credit Card Market (MIT Working Paper, 2018); Sumit Agarwal, et al., Regulating Consumer Financial Products: Evidence from Credit Cards, 130 Q. J. Econ. 111 (2015); Oren Bar-Gill and Ryan Bubb, Credit Card Pricing: The CARD Act and Beyond, 97 Cornell L. Rev. 967 (2012).

[367] Durkin, Et al., *Assessment*, *supra* note 361, at 46-52; Todd Zywicki, *No, the Credit Card Act is Not a Free Lunch*, Washington Post (Jan. 13, 2016). In fact, Agarwal, et al., does not even mention the 2008 Federal Reserve regulations. Bubb and Bar-Gill mention only the Federal Reserve's CARD Act regulations that accompanied the CARD Act but do not mention the 2008 Regulations (their timeline of significant events begins with the enactment of the CARD Act in May 2009). Nelson mentions the 2008 Federal Reserve regulations but makes no further effort to control for any effect they might have had on the credit card market.

[368] *See* Bar-Gill and Bubb, *supra* note 366 (identifying the "before" period as February 2010-August 2010); Nelson, *supra* note 366, at 8 (identifying "before" period as July 2008 to June 2009), Agarwal, et al., *supra* note 366366 (identifying "before" period from March 2008 to April 2009). As noted by Dou, et al., summarizing the problem, "While our sample and design differ from [Agarwal, et al.] in many aspects, one key difference is that our anticipation period [2008Q1-2009Q1] largely overlaps their pre-period (March 2008-April 2009). Since the effect of the CARD Act first appears in our anticipation period and persists afterward… it is unsurprising to observe insignificant changes from the anticipation period to [the CARD Act] period. Our findings highlight the importance of identifying the timing of the treatment effect and choosing the pre-period accordingly."[368] As a result, by failing to control for the overall effects of relevant regulation, these studies are not meaningful efforts to assess the effects of the overall combined effects of the Federal Reserve regulations and CARD Act on consumer welfare.

increased use of personal installment loans where possible, which feature higher interest rates and other costs than the credit cards that they previously used.

The CFPB recently summarized its conclusions about the overall effects of the CARD Act on consumers since its enactment and implementation.[369] With respect to card fees, the CFPB concluded that (1) over-the-limit fees and late fees have declined, (2) the size and prevalence of annual fees have increased, and (3) total fees have declined overall. The CFPB also concluded that the account-weighted average APR on card accounts had increased by 230 basis points and that the CARD Act had clear adverse effects on credit availability, especially for consumers with subprime scores and young adults, as well as stricter limits on credit lines.

To date, researchers have not attempted to measure the net welfare costs of these offsetting adjustments to the CARD Act, especially for higher-risk and lower-income consumers or the overall impact of those regulations on financial inclusion and competitive conditions in the credit card marketplace. Available research suggests that these costs could be significant, especially when considering the shift in use by consumers of higher-cost alternative sources of credit, such as installment loans. In states where installment loans are not available, it is not clear what products consumers substituted instead.

10.6.2 Postal Banking

One common proposal put forward from time to time to increase financial inclusion is to permit the United States Postal Service to offer consumer financial products in some fashion or another. The contours and details of what a postal banking system would include tend to be somewhat vague and ill-defined.[370] Some proposals are quite modest, suggesting a role for the Postal Service in providing money orders, remittances, and other alternative financial products. Other postal banking proposals focus on enabling the Service to provide transaction and savings accounts for consumers. Broader but even more undefined proposals would enable the Post Office to go beyond provision of these limited financial services and to make small-dollar loans as a competitor to existing payday and personal installment lenders.[371] Because suggestions are largely undefined, detailed discussion of postal banking proposals is largely beyond the scope of the Taskforce report, but it also seems like postal banking is unlikely to promote increased

[369] *See* Bureau of Consumer Financial Protection, CARD Act Rules Review Pursuant to the Regulatory Flexibility Act; Request for Information Regarding Consumer Credit Market 15-16, 85 FR 53299, 12 CFR 1026 (Aug. 28, 2020)

[370] *See* United States Postal Service, Office of Inspector General, The Road Ahead for Postal Financial Services (May 21, 2015); *see also* Mehrsa Baradarn, *It's Time for Postal Banking,* 127 Harv. L. Rev. F. 165 (Feb. 24, 2014); Mehrsa Baradaran, *How the Poor Got Cut out of Banking,* 62 Emory L. J. 483 (2013).

[371] The proposal to enable the post office to make small-dollar loans is largely underdeveloped and we do not discuss it here.

financial inclusion compared to public policies directed toward promoting greater competition from existing innovators and competitors.

From 1911 to 1966 the Post Office provided limited financial services through the Postal Savings System.[372] The modern argument for postal banking primarily rests on the large number of existing physical Postal Service buildings in the United States today and the declining foot traffic and use of these facilities as consumers shift away from traditional postal delivery. This excess physical capacity and the ubiquity of branches, it is sometimes argued, could be put to work to provide banking services to residents of lower-income communities with limited bank branches.[373]

In practice, it is questionable whether Postal Banking would do much to meaningfully increase financial inclusion. Focusing on locational convenience appears to offer a solution to a non-problem aspect of the unbanked issue and fails to address actual problems for unbanked consumers. According to the most recent FDIC survey of unbanked consumers, only 14 percent of unbanked consumers list "Bank Locations are Inconvenient" as a reason for being unbanked and only 2 percent list it as the primary reason, the eighth of nine enumerated options provided in the survey.[374] In short, lack of physical access to a bank appears to present a relatively small barrier to inclusion for most unbanked consumers; therefore, investing substantial sums to build out banking services in Post Offices and the relevant personnel, physical, and technological infrastructure is likely to have a small return on social investment, and it could have a negative return.[375]

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372 *See* Diego Zuluaga, *Postal Savings: A Third-Class Remedy?*, Alt-M.org (Sept. 22, 2020), *available in* https://www.alt-m.org/2020/09/22/postal-savings-a-third-class-remedy/.

373 According to an estimate by a pro-postal banking organization, there are more than 30,000 Post Office retail locations around the country. *See* Campaign for Postal Banking, http://www.campaignforpostalbanking.org/know-the-facts/.

374 *See* 2019 FDIC Survey, *supra* note 129, at 17 Fig. 3.5.

375 Due to its status as a federal government agency, a Postal Service bank in whatever form it takes is also unlikely to provide a solution to consumers who are unbanked either because of privacy concerns or lack of sufficient documentation to open a bank account, such as citizenship requirements or anti-money laundering regulations. Proponents of Postal Banking also have pointed to the observation discussed above that another commonly-state reason by unbanked consumers for their lack of interest in a bank account is that they "Don't Trust Banks." As discussed earlier in this chapter, this seems to be an umbrella answer for more general concerns relating to feeling welcome and valued as customers instead of pure "trust." The history of the country's first "postal bank" that operated from 1910-1966 is consistent with that observation. As noted by Diego Zuluaga, the original postal banking system was established in 1910 following the banking Panic of 1907 as an indirect mechanism for the federal government to guarantee personal deposits. Part of its stated mission was to offer savings accounts with a "comparatively low rate of interest." Zuluaga, *Postal Savings*, *supra* note 372. The establishment of deposit insurance during the New Deal obviated that insurance rationale and led to an inevitable outflow of household savings from the Post Office to

Based on its history, it seems unlikely that the Postal Service can compete on the terms and qualities that financial services customers expect today—speed, efficiency, and adoption of innovative technologies that provide greater convenience, variety, and lower cost.[376] It also seems that the Postal Service will be unable to offer a meaningful response to those unbanked consumers who lack bank accounts because "bank hours are inconvenient,"[377] a margin on which alternative financial services providers compete. With respect to the cost of the financial services, even with its subsidized business structure the Post Office currently charges higher prices for the financial products and services it available, including check cashing and money orders, than competitors like Walmart.[378] Increased competition and innovation in the market for money transfers and remittances has driven down the price of those products elsewhere.[379] Retailers such as Walmart also currently offer longer hours that are more convenient for financial activities than the Postal Service.[380] Moreover, a primary reason why many low-income consumers use products such as check cashers and money orders is to address the chronic problem caused by the slowness of the payment-clearance system. Unless there is some reason to believe the Postal Service would be able to clear checks more rapidly than commercial banks currently do, demand for check cashing, money orders, and small-dollar loans is likely to be only marginally impacted by the provision of Postal Banking services. Reforms such as adoption of a faster payments system seems like a more relevant avenue.

In the end, it appears that the essence of a Postal Banking system is primarily a subsidized public utility model of banking services coincidentally hitched to the Postal System because of the excess capacity provided by its legacy real estate holdings. If Postal Banking largely boils down to providing subsidies for basic transaction accounts as a public service, then it is not obvious why the best way to effectuate those subsidies is through in-kind subsidies offered by

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commercial bank accounts that offered the same guarantees but at a higher level of interest and service. *See* Diego Zuluaga, *Going Postal? Proposals for Post-Office Banking in 2020*, www.Alt-M.org, *available in* https://www.alt-m.org/2020/10/16/going-postal-proposals-for-post-office-banking-in-2020/.

376 See Todd Zywicki, Postal Banking Isn't the Fix for Financial Inclusion, American Banker (June 13, 2019).

377 The number of survey respondents who identify inconvenient bank hours as a reason for being unbanked is about equal to the number who blame inconvenient locations with slightly more identifying inconvenient hours as the "main" reason for being unbanked. *See* 2019 FDIC Survey, *supra* note 129, at 17, Fig. 3.5.

378 *See* Zywicki, *Postal Banking, supra* note 376 (noting that Walmart typically charges 88 cents for a money order compared to $1.25 at the Post Office).

379 *See* Mauro F. Romaldini, *How Is the International Money Transfer Market Evolving?*, www.Toptal.com (undated), *available in* https://www.toptal.com/finance/market-research-analysts/international-money-transfer. In addition to general technological cost efficiencies that have reduced costs (and prices), one FinTech innovation has been to use a "peer-to-peer" model of matching consumers' transactions off against each other, thereby eliminating the need to transfer currencies manually via transactions with third parties in the interbank market. Although that process is unlikely to eliminate interbank remittances entirely because it requires a symmetry of flows between countries, for many transactions it can eliminate or dramatically reduce costs.

380 *See* Zywicki, *Postal Banking, supra* note 376.

the Post Office through its existing locations instead of providing subsidies, tax benefits, or some other government-provided incentives for the private sector to provide those services. A more promising strategy, for example, might be to provide subsidies for consumers to acquire prepaid cards or bank accounts from private banks, rather than forcing them to deal with a single monopoly governmental provider for financial services. It is also not obvious why of all the services that could be provided at existing Post Office locations, financial services is the highest-value use of that excess real estate capacity instead of other potential social services.

The future of financial inclusion is online. For all its virtues as a 20th century public utility with economies of scale and large network of physical locations, it is difficult to see how the Postal Service is primed to provide innovative, convenient, timely, and low-cost products as financial services become increasingly electronic and mobile, and increasingly less dependent on physical access to bricks-and-mortar buildings and 9-to-5 hours of operation.[381]

10.6.3 Promoting Competition Through Industrial Banks and FinTech

The Taskforce believes that competition, entry, and innovation are better ways to promote greater financial inclusion. This could mean clearing away existing regulatory and other barriers to entry by non-traditional suppliers such as traditional and online retailers such as Walmart and others with broad experience at reaching a broad diversity of customers.[382] In this vein, the Taskforce has been pleased to see the FDIC's recent actions to lift its longstanding moratorium on approving the applications of new industrial bank charters[383] and to propose a new rule for chartering industrial banks and industrial loan companies.[384] As discussed in Chapter 9, the Taskforce also endorses the principle of some sort of federal financial charter for FinTech firms and other firms with inherently interstate operations, such as money transmitters, that would enable them to operate under a reasonably uniform set of laws nationwide. It is the view of the Taskforce that eliminating archaic barriers to competition and innovation from new providers

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[381] *See* Testimony of Merhrsa Baradaran before the United States House of Representatives Committee on Financial Services Task Force on Financial Technology (June 11, 2020) (arguing that the banking and payments systems should be understood as public utilities).

[382] *See* Zywicki, *Postal Banking, supra* note 376.

[383] *See* Anna Hrushka, *Rakuten to Continue ILC Charter Pursuit, Subsidiary CEO Says*, BankingDive.com (Aug. 26, 2020), *available in* https://www.bankingdive.com/news/rakuten-to-continue-ilc-charter-pursuit-subsidiary-ceo-says/584189/.

[384] *See* Federal Deposit Insurance Corporation, *Parent Companies of Industrial Banks and Industrial Loan Companies*, 85 Fed. Reg., No. 62, at p. 17771 (Mar. 31, 2020).

and regulatory restrictions that increase the costs of bank accounts and undermine natural market incentives to seek new customers will prove far more effective at promoting financial inclusion for those who need it than trying to retrofit a 20th century-model of financial services to a 21st-century financial marketplace.

10.6.4 A Better, Faster, and More Innovative Banking and Payments System

A major barrier to greater access and higher quality in financial services is the antiquated payments system in the United States. As discussed earlier, adoption of a faster system of payments clearance would reduce the need for some consumers to rely on alternative financial service providers to gain access to their funds in a way that pays bills and avoids costly bank fees and bounced checks. There are several proposals currently under consideration to implement faster payments. The Taskforce does not endorse one proposal over the other. On the other hand, the slow pace of change in the United States is frustrating and costly for consumers, especially low-income consumers operating at the financial margin. Such a system is possible—the United Kingdom switched to instant or "real-time" payments over a decade ago.[385]

The emergence of FinTech-based earned wage access programs also provides a useful innovation to enable consumers to better address lags in the timing of access to funds.[386] Most private businesses use biweekly, semimonthly, or monthly pay periods, which creates a lag between the time that workers earn wages and the time they are actually received. This can create a need for short-term liquidity including the potential use of short-term, small-dollar credit.[387] As noted by the Bureau in its recent issuance of an Advisory Opinion that recognizes the value of earned wage access programs under certain conditions, these programs provide a convenient and speedy mechanism for workers "to meet short-term liquidity needs that arise between paychecks without turning to more costly alternatives like traditional payday loans."[388] Although there are costs to workers from using earned wage access programs, in light of the technical, economic, and financial challenges for many employers in disbursing wages more frequently than they currently do, earned wage access programs appear to provide a useful and

[385] *See* Selgin and Klein, *supra* note 144.

[386] *See* Bureau of Consumer Financial Protection, Advisory Opinion: Truth in Lending (Regulation Z); Earned Wage Access programs (Nov. 30, 2020).

[387] *Id.* at 2.

[388] *Id.* at 3.

potentially less-expensive alternative to the usage of small-dollar loans and overdraft protection to meet liquidity needs between paychecks.

Financial inclusion also would be furthered by reforming how financial institutions provide bank accounts to unbundled transaction services from other elements. Traditional banking relationships offer in a single relationship an array of standardized and convenient products and services suitable for the vast number of middle-class Americans. Banks provide a combination of products to consumers—they simultaneously provide transaction account service and a lending and borrowing service. Transaction accounts provide the ability to write checks or process ACH, debit, or credit transactions, all of which rest on consumers' access to bank accounts. But at the same time, banks offer a variety of lending and borrowing services—for example, banks pay interest on savings and money market accounts because of their ability to convert those deposits into loanable funds.

This second tranche of services, such as the sale of loans and other financial products, are responsible for both a disproportionate amount of the costs and risks of banking, as well as its profits. But this system of multiple products creates a complex system of potential cross-product and cross-consumer subsidies to try to maximize the bank's revenue streams and customer base.[389] For instance, consumers who use other bank products, such as mortgages or overdraft protection, provide subsidies to those consumers who do not. And consumers who use expensive services, such as bank tellers and physical branch locations, are subsidized by those consumers who rarely use those services.

The economic logic of combining financial services within one provider is compelling for both consumers and providers. For consumers, dealing with one primary financial institution provides efficiencies in transaction costs. With respect to providers, providing multiple products allows economies of scope in product offerings; for example, one bank branch with half a dozen employees can offer a wide array of products from car loans to checking accounts to money transfer services. In addition, by offering an array of services, banks can gain enough participation in consumers' finances that they can recommend products that will best meet their needs (cross selling).

[389] For example, with respect to savings and demand deposit accounts, consumers who maintain a higher balance consumers (who are also usually higher-income) provide subsidies to consumers with lower average balances. Consistent with the Pareto (or "80-20") principle, 85.7% of consumer checking accounts represent only 17.2% of the dollar balances and 14% of checking accounts provide 83% of the checking account balances. Yet deposit holders who provide much larger balances receive only slightly higher rates of interest than those who provide far less. *See* G. Michael Flores and Todd J. Zywicki, *Commentary: CFPB Report Data Point: Checking Account Overdraft* 8 (Sept. 2014), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2499716.

Economists have long understood that these transaction costs and internal information flows help to explain decisions by firms to offer products in a bundled or unbundled fashion.[390] Firms will tend to grow in size so long as the savings from greater economies of scope and internal management of production exceed the costs of managing a far-flung and diverse enterprise with hundreds or thousands of employees. For several decades, banks grew in size and complexity so as to capture economies of scope and to offer an increasingly complex array of products and services.[391]

Over the past two decades, however, technological innovations have disrupted these kinds of relationships dramatically, not just in domestic financial services but across the entire global economy. In some instances, these innovations have driven down information costs sufficiently to generate massively scaled companies with hugely complex consumer ecosystems. In other markets, however, these same dynamics have driven unbundling of the consumer experience by enabling providers to generate well-designed, boutique-style products at low cost and designed to meet specific needs of specific consumers in ways not being met adequately by supermarket-style product offerings. In these markets, the opportunity to offer these highly tailored niche products to many consumers without the constraints of physical location have generated an unbundling of consumer banking as consumers increasingly interact with multiple different financial service providers to meet their needs instead of only one institution. This ability and willingness to engage in product unbundling appears to be particularly common among younger consumers who are comfortable with shopping on the Internet and using multiple different providers for different purposes.

Today, the evolution of consumer financial services is rendering increasingly obsolete the traditional association of financial inclusion with ownership of a bank account. Today, many consumers increasingly use a mixture of financial services like accounts that provide transaction capability with "alternative" (non-bank) providers. For example, by far the fastest-growing nontraditional financial product according to the FDIC is peer-to-peer, app-based payments such as Venmo, a category of "alternative" financial products which hardly even existed a few years ago.[392] Despite its novelty, peer-to-peer payments were used by almost one-third of the respondents in the 2019 FDIC survey of unbanked consumers, far outpacing the usage by any

[390] *See* Ronald Coase, *the Nature of The Firm*, 4 Economica 386 (1937); *see also* Charles Calomiris and Thanavut Pornrojnangkool, *Relationship Banking and the Pricing of Financial Services*, 35 J. of Fin. Servs. Research 189 (2009).

[391] See Charles W. Calomiris, Gauging the Efficiency of Bank Consolidation During a Merger Wave, 23 J. of Banking and Fin. 615 (1999).

[392] 2019 FDIC Survey, *supra* note 129, at 6 (noting that the 2019 survey was the first to ask about use of peer-to-peer payments).

other nonbank financial transaction service.[393] Indeed, use of these products, especially among certain subsets of consumers, has become so ubiquitous that many consumers might not even think of these products as "alternative" in nature. They are simply viewed as a complement to traditional financial services that meet a need for faster payments through a user-friendly interface.[394] In fact, those who use peer-to-peer payment systems are four times more likely to be banked than unbanked. Not surprisingly, those who use peer-to-peer payments tend to be high income, college educated, and younger. So much of the commentary on the value of unbundling bank account services for financial inclusion has focused on "FinTech *lenders*," i.e., those companies that are using alternative data and other underwriting and servicing technological innovations to provide small-dollar loans. These innovations are important for promoting financial inclusion and are discussed elsewhere in the Taskforce report.

Disconnecting transaction capabilities from bank accounts also provides promise for financial inclusion for consumers. Transactional services are increasingly electronic in nature, incurring minimal marginal costs and with little expensive human intervention and oversight. Many consumers only need access to bank accounts primarily for transactional purposes and do not need the panoply of bank services. The value of having widespread access to a transaction account was illustrated during the COVID-19 pandemic and the federal government's financial stimulus efforts.[395] Those consumers who had bank accounts were able to have the government deposit those funds directly into their accounts. Those who did not have an account, by contrast, had to wait to receive their stimulus checks (sometimes weeks) or pay fees to alternative financial service providers to cash their checks.

The emergence of low-overhead branchless banks provides one potential mechanism for providing low-frills inexpensive bank accounts. Prepaid cards have evolved to meet some consumer demand for transaction services without the need for a formal bank account and provide a foundation for future unbundling of transaction accounts from traditional bank accounts.[396] Prepaid cards are almost four times more likely to be used by unbanked consumers

[393] *Id.* at 35, Fig. 6.1 (noting that P2P Payment Service was used by 31.1 percent of respondents and the category of "Money Order, Check Cashing, or Bill Payment Service" was second at 17.2 percent).

[394] And, in fact, the competitive pressures provided by the rapid growth Venmo and similar providers prompted banks to respond with their own real-time peer-to-peer payments system named Zelle.

[395] *See* Testimony of Merhrsa Baradaran before the United States House of Representatives Committee on Financial Services Task Force on Financial Technology (June 11, 2020).

[396] General-purpose prepaid debit cards now account for 10.5 percent of all card payments in the United Staes. *See* Board of Governors of the Federal Reserve System, The 2019 Federal Reserve Payments Study (2019); *see also* Todd J. Zywicki, *The Economics and Regulation of Network Branded Prepaid Cards*, 65 Fla. L. Rev. 1477 (2013).

than among the overall population.[397] Prepaid cards issued by large banks, however, are subjected to the Dodd-Frank Act's price controls on debit card interchange fees under certain conditions, and this, in turn, has required major banks either to provide cards with limited functionality or to impose fees on consumers. Eliminating price controls on debit card interchange fees generally, or their application to prepaid cards specifically, would help to enable prepaid cards to evolve into functional, lower-cost transactional and simplified mobile banking platforms that would effectively meet the needs of many consumers who do not want or need the entire package of services offered by a traditional banking account. Digital wallets are also becoming increasingly available to provide transactional services.

Lower-income and unbanked consumers are also more likely than the average American to use cash for transactions and to carry larger amounts of cash.[398] In addition to the obvious risks associated with higher cash usage (loss or theft), they pay higher costs on aggregate for cash access, including the time and convenience costs of having to travel to acquire cash from ATMs or check cashers. Wealthier Americans with bank accounts carry smaller amounts of cash on average, travel less to access cash, and pay few, if any, fees. During the COVID-19 pandemic, many consumers also expressed a heightened fear of cash as a transmitter of disease and many consumers switched to electronic and touchless payments to reduce their contact with cash.[399]

FinTech providers have been active in developing products that can provide low-cost or free transaction accounts to consumers.[400] The ability of these upstart entrants to provide free or low-cost services seems to result from several sources. First, these payments companies typically operate by partnering with a smaller bank (one that is below the $10 billion asset threshold established by the Dodd-Frank Act) to process their payments. As a result, these FinTech payments companies can cover most of their operating costs through interchange fee revenues. Second, because they operate only online without the cost and capital expense of bricks and mortar (such as branches and the ATM network) and can replace substantial amounts of employee costs with heavy reliance on technology, FinTech payments processors have much lower operating costs than traditional banks. Third, payments data offers providers of these services visibility into consumers' shopping and financial habits in ways that they can use to

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[397] 2019 FDIC Survey, *supra* note 129. In 2019 27.7 percent of unbanked households used prepaid cards, compared to 7.4 percent of banked households.

[398] *See* Bhaskar Chakravorti & Benjamin D. Mazzotta, The Cost of Cash in the United States, The Institute for Business in the Global Context, Tufts University Fletcher School (Sept. 2013).

[399] *See* Jeff John Roberts, *Most Americans Now Fear Touching Cash, Survey Says*, Fortune.com (Aug. 11, 2020), *available in* https://fortune.com/2020/08/11/coronavirus-is-cash-safe-during-covid-germs-money/.

[400] *See* Hugh Son, *Chime is Now Worth $14.5 Billion, Surging Past Robinhood as the Most Valuable U.S. Consumer FinTech* (Sept. 18, 2020), *available in* https://www.cnbc.com/2020/09/18/chime-is-now-worth-14point5-billion-surging-past-robinhood-as-the-most-valuable-us-consumer-FinTech-.html.

develop new or tailored product offerings to consumers. Offering free or low-cost transactions services may also be an effort to establish a lifetime relationship with consumers. They may also be useful for immigrants who face short-run obstacles to accessing bank accounts and traditional financial services.[401]

Regulators should consider allowing non-banks access to the payments processing system as a vehicle for enabling consumers to gain access to low-cost and convenient payments processing. Barring non-banks from access to the payments system creates a chokehold between some consumers and better, less expensive, and innovative payments systems and it drives consumers toward traditional bank accounts that have not met their needs. The Taskforce is aware that there are challenges and offsetting concerns associated with this proposal, especially concerns about risk to consumers and the financial system as well as concerns about anti-money laundering.[402] On the other hand, it sees great potential to enabling consumers to access payments and other transactional financial services without the accompanying cost and complexity of a bank account. Expanding the pool of possible payments providers to include non-banks also would likely increase entry, competition, and innovation in this realm, leading to further improvements.

Non-bank provision of payments services by telephone companies and others is common in other countries with great benefits to consumers. The evolution of Kenya's M-Pesa telephone network into a payments system is one of the most well-known and established non-bank provider of payments. Throughout sub-Saharan Africa today there are more registered mobile money accounts than the total number of bank accounts in the region.[403] Other technology companies are developing technological solutions that have enabled consumers to move in and out of existing payment and banking relationships.[404]

The consumer payments revolution in China, however, may be the most promising example of the potential benefits to consumers in the area of payments that competition and innovation

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[401] FinTech can also provide solutions for other issues that disproportionately affect higher-risk borrowers. For example, a company called Convoke has developed a cloud-based accounts receivable and collections platform that addresses many of the problems of information and document retrieval that is a common source of consumer complaints over debt collection. *See Convoke Adopted by 15 of the Top Debt Buyers in the USA* (Jan. 19, 2011), *available in* https://www.insidearm.com/news/00039607-convoke-adopted-by-15-of-the-top-debt-buy/.

[402] *See* Bank for International Settlements, Non-Banks in Retail Payments (Sept. 2014); *see also* Barak J. Sanford and Daniel Bufithis-Hurie, *Should non-Bank Payment Firms Be Eligible to Open Federal Reserve Accounts*, Banking Perspectives (Fourth Quarter 2018) (Nov. 25, 2018).

[403] *See* Tilman Ehrbeck and Alex Lazarow, *Now that FinTech Has Unbundled our Financial Lives, Can it Re-bundle Them?*. Medium.com (Jun 29, 2017), *available in* https://medium.com/positive-returns/now-that-FinTech-has-unbundled-our-financial-lives-can-it-re-bundle-them-fd34a0946840.

[404] Id.

have provided. As analyst Aaron Klein put it, "China has experienced a retail payment revolution. Leapfrogging the card-based system, two new payment systems have come to dominate person-to-person, retail, and many business transactions."[405] These "two new payments systems" are Alipay (which runs through Alibaba, China's largest online retailer) and WeChat Pay (which runs through China's dominant social network), each of which now reports more than one billion monthly users of their payments services and processing more than $41 trillion (277 trillion yuan) annually.[406] Available funds are stored in digital wallets and are transferred through unique Quick Response (QR) codes scanned through smart phones, a system that largely disintermediates banks from payment transactions.

In the United States, large retailers such as Amazon and Walmart or social networks, such as Facebook, have explored the creation of similar payment networks.[407] Large online social and gaming networks are potentially fertile sources to develop robust internal payment networks. In the United States, however, efforts to establish new payment networks have met with regulatory challenges, some of which raise legitimate concerns about security, safety, and anti-money laundering. Other objections, however, may primarily reflect political efforts by banks and other incumbent financial services providers to stifle entry from innovative new competitors, much as traditional banks fought Walmart's entry into banking a decade ago.[408]

Over the longer term, another potential additional source of innovative solutions to financial inclusion challenges is the use of blockchain and other cryptocurrencies, particularly stable-value coins, which can reduce or eliminate the need to maintain a bank account to make payment transactions.[409] As traditional employment relationships evolve under the pressures of the "gig economy" and other new work arrangements, these sorts of peer-to-peer payments systems could become increasingly common, enabling the establishment of novel forms of payments and transactions that have minimal and sporadic interactions with the payment systems. Because of their secure and instantaneous nature, these payment technologies also

[405] *See* Aaron Klein, China's Digital Payments Revolution (Apr. 2020), *available in* https://www.brookings.edu/research/chinas-digital-payments-revolution/.

[406] *Id.*

[407] *See id.* at 15-16; *see also* Lucas Jankowiak, *Payments Innovation Is "Unbundling" Banking*, www.PaymentsSource.com (Apr. 17, 2017), *available in* https://www.paymentssource.com/opinion/payments-innovation-is-unbundling-banking.

[408] *See* Craig Torres, *Bankers Advising Fed Board Describe Libra as a Monetary Threat*, www.Bloomberg.com (Sept. 30, 2019), *available in* https://www.bloomberg.com/news/articles/2019-09-30/bankers-advising-fed-board-describe-libra-as-a-monetary-threat.

[409] See Amit Sharma, Underbanked Households Would Benefit from a Regulated Blockchain, American Banker (Aug. 26, 2020).

could eliminate the cost and inconvenience resulting from the delays built into the current payments clearance system.

Growth of peer-to-peer and nonbank provision of payments provide novel challenges to the regulatory framework but also novel and revolutionary opportunities for consumer benefits. Innovations such as promoting faster payments and eliminating regulatory barriers that reduce access to traditional bank accounts are important short and medium-term solutions for increasing access within the traditional financial system. But improvements to these systems can be thought of as being analogous to proposals to increase the quality of a 20th-century landline telephone network to make them clearer and more reliable, as opposed to recognizing the opportunity for cellphone and smartphone networks to leapfrog those legacy systems using 21st-century technology.

10.7 Eliminate Regulatory Barriers That Prevent Access to Financial Products That Could Make Invisible Consumers Visible

Regulators should reconsider legal and regulatory barriers that indirectly interfere with becoming a scorable consumer by depriving lower-income, higher-risk, and younger consumers by depriving them of entry-level financial products that can enable them to establish a credit report.

10.7.1 Eliminate Restrictions on Subprime Credit Cards

A major reason that many consumers are credit invisible is because they simply have not had an opportunity to establish their credit or have damaged credit that they would like to have an opportunity to repair. Yet options are limited for mechanisms to do so. For many consumers, access to credit cards can provide a first step on the ladder to establish or reestablish credit. In fact, according to one recent survey, the most commonly stated reason (62 percent of respondents) for consumers wanting to have a credit card is "To build credit history." [410] According to a 2017 CFPB Report, 37.6 percent of newly credit visible consumers used a credit

[410] *See* The Ascent, *Why Swipe? American Credit Card Preferences and Habits by Generation,* Fool.com (Mar. 5, 2019), *available in* https://www.fool.com/the-ascent/credit-cards/articles/study-why-swipe-american-credit-card-preferences-and-habits-by-generation/.

card as an “entry product” to become credit visible.[411] For new or subprime consumers, however, credit cards can be extremely difficult to obtain.

Congress should examine and potentially reconsider provisions in the CARD Act that limit issuance of “subprime” credit cards.[412] Subprime credit cards are cards that have low initial credit limits, such as $300 to $500. Unlike prime credit cards, which are designed to serve transactional and borrowing functions, a primary function of a subprime credit card is as a product to establish or rebuild credit while also providing an electronic transactional device. Under the terms of subprime credit card agreements, a consumer that makes regular payments on their card for a certain period, usually 12 months, become eligible to transition out of the subprime card into a regular card. Marketing materials prominently promote that the card is available to those with no credit history or a low credit score, that the card issuer will report payment performance to the three national credit reporting agencies, that the customer will gain free access to their credit score reports, and that the issuers will regularly evaluate the account for potential increases in credit lines depending on account performance. Most consumers do not see subprime credit cards as long-term solutions to their financial challenges but instead as a transitional product to establish or reestablish credit. In fact, many subprime credit card customers were able to improve their credit bureau scores and qualify for prime credit after a short period of time.[413]

Subprime cards can either be secured or unsecured in nature. For a secured credit card, the cardholder deposits several hundred dollars with the issuer, which can be used as collateral to offset any losses if the consumer defaults. The size of the available line of credit is typically capped at the size of the initial deposit. The issuer typically retains any interest earned on the collateral and the collateral deposit is held by the issuer until the account is closed or the consumer is eligible to refinance into an unsecured card. Secured subprime credit cards typically offer lower interest rates and lower upfront and annual fees than unsecured subprime cards; in fact, the interest rate on a secured subprime card is often lower than for a mainstream credit

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[411] *See* Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible 15 (2017) (finding that only 5 percent of previously credit invisible consumer who used a credit card as an “entry product” to become credit visible used secured cards and less one percent of those under the age of 25 used secured cards).

[412] *See* Durkin, Et al., *supra* note 25, at 357-59 (discussing subprime credit cards). Chapter 12 discusses various provisions of the CARD Act that create obstacles to younger consumers obtaining a credit card and establishing credit.

[413] *See* Durkin, Et al., *supra* note 25, at 358.

card.[414] On the other hand, in order to obtain a secured card, the consumer must come up with a substantial up-front deposit, which is usually refundable, and must agree to keep that money locked up for a set period of time.

For an unsecured credit card, processing and annual fees were often high relative to the amount of the available credit line that was granted. For example, prior to the enactment of the CARD Act, which limited initial fees to 25 percent of the credit line granted, the initial available credit on a $300 credit line might be restricted by a $19 processing fee and a $75 annual fee, leaving an available credit line of $206. Interest rates on unsecured subprime cards are higher than for secured cards and usually slightly higher than mainstream credit cards, but still far below the triple-digit pricing of the alternative financial products described in Chapter 5. Fees and interest rates are higher than for secured credit cards.[415] Nevertheless, subprime consumers will often prefer an unsecured card because of the challenge of coming up with sufficient liquidity to make a large upfront deposit and then to keep that liquidity frozen for the duration of the card term.[416] Because of these constraints, many subprime consumers will be unable to qualify for a secured card or will find secured credit cards to be undesirable.[417] Because no security deposit is required on an unsecured card, the consumer can refinance out of the subprime card at any time and after several months of successful payments could improve their credit score and become eligible for a lower-priced card from the same or other providers.

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[414] *Id.* For example, consumer finance aggregator websites report several offers ranging from 9.99% with a $49 annual fee and $200 refundable minimum deposit to 17.45% with a $36 annual fee and $200 minimum refundable deposit. *See Secured Credit Cards*, Creditkarma.com (Dec. 21, 2020), *available in* https://www.creditkarma.com/credit-cards/secured-credit-cards. For purposes of comparison, one consumer finance website, the average card interest rate on regular credit cards during October 2020 was 17.98% for new offers with a wide range. *See* Adam McCann, *What is the Average Credit Card Interest Rate?*, Wallethub.com (Oct. 12, 2020), *available in* https://wallethub.com/edu/cc/average-credit-card-interest-rate/50841#:~:text=The%20average%20credit%20card%20interest%20rate%20is%2017.98%25%20for%20new,card%20APRs%20worth%20considering%2C%20too. According to McCann, the average APR on a secured card was 17.39% while those with excellent credit have an average of 13.03%. *Id.*

[415] According to one aggregator website, the annual fee on unsecured subprime credit cards typically ranges from $75-$99 and interest rates generally fall in a range between 24.9% to 35.99%. Some unsecured subprime credit cards also assess a monthly fee in addition to an annual fee as well as a one-time fee around $89-$95. The standard spending limit is $300. *See Unsecured Credit Cards for Bad Credit*, www.Wallethub.com (Dec. 21, 2020), *available in* wallethub.com/credit-cards/bad-credit-unsecured/.

[416] *See Best Subprime Credit Cards—March 2020*, Banks.com (Mar. 12, 2020), *available in* https://www.banks.com/articles/credit/credit-cards/subprime-credit-cards-march-2020/ ("When you are hesitant to tie up a portion of your personal savings without a "set" date to retrieve them should you need them, an unsecured subprime credit card may be a better option [than a secured subprime card].").

[417] *See* Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible 15 (2017) (finding that only 2 percent of previously credit invisible consumers used a secured credit card to become credit visible and only 5.6 percent of those who used a credit card as an "entry product" to become credit visible used a secured card).

The unusual terms of unsecured subprime credit cards, and the fact that subprime credit cards exist at all, reflects the unusually high cost and risk associated with subprime credit card operations.[418] Rejection rates on applications are high, imposing costs on the issuer in terms of verification and processing.[419] Loss rates from defaults and delinquencies are exceedingly high, as would be predicted in dealing with a group of high-risk consumers.[420] Moreover, subprime issuers face an adverse selection problem—because of the nature of the product, those consumers who establish themselves to be reliable payers will improve their credit scores rapidly and have the opportunity to refinance out of the subprime card into a less-expensive card, leaving the remaining pool to be dominated by poor risks and narrowing the pool of reliable customers from which losses from delinquent customers could be recouped. Subprime credit card customers also used virtually all of their available credit (98 percent) and defaulted early in their term (about three-fourths of charge-offs occurred within the first three months) thereby imposing high losses on the issuer.[421] The unusual pricing structure of unsecured subprime credit cards reflects these economic realities. High upfront fees are necessary to offset the high cost and risk associated with these loans.[422]

The CARD Act placed new limits on unsecured subprime credit cards, capping upfront fees at 25 percent of the initial credit line. Following the enactment of the law, subprime credit card issuance and lending declined.[423] In addition, interest rates on subprime cards rose and credit limits fell. As a result, consumers have lost access to one potentially useful tool for establishing a credit record or repairing their credit. As described, secured subprime cards are not a viable or desirable alternative for many consumers as they require substantial upfront security deposits and a willingness to keep those funds locked up for some period of time.

The opinion of the Taskforce is that Congress should reconsider the price controls imposed on subprime credit cards by the CARD Act so as to make this option available once again to a wider range of consumers. The Taskforce acknowledges the concerns of those who supported this

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418 *See* Durkin, Et al., *supra* note 25, at 358.

419 Prior to the CARD Act, one subprime credit card issuers reported a rejection rate of two-thirds of applicants. *Id.* at 358, n. 11 (citing Miles Beacom, *Letter from Premier Bankcard to Board of Governors of the Federal Reserve System Regarding Proposed Revisions to Regulation AA,* Fed. Res. Docket No. R-1314 (July 31, 2008)).

420 Prior to the CARD Act, one subprime credit card issuer indicated that about half of subprime accounts had one or more delinquencies of ninety days or more in the first twenty-four months after account opening and 30 percent charge-off all or part of balances owed. Durkin, Et al., *supra* note 25, at 358, n.11.

421 *See* discussion in Durkin, Et al., *supra* note 25, at 358, n. 11 (citing Michael A. Turner and Patrick D. Walker, *Impact of Proposed Fee Cap on the Subprime Card Industry,* Political and Economic Research council, Center for Competitive Credit (Sept. 2008)).

422 *See* Durkin, Et al., *supra* note 25, at 358.

423 *See* Han, Keys, and Li, *supra* note 350.

provision of the CARD Act that upfront fees on these cards are high. But these are intended to be transition products designed to enable consumers to prove their creditworthiness and to transition to less-expensive products, not a permanent solution to the consumer's needs. For many credit invisible and unscorable consumers there are limited alternative options that are viable for them to establish credit records. The Taskforce can see no reason why the terms of these cards should be treated any different from other credit cards, requiring transparent and accurate disclosure of their terms and conditions instead of dictating the substantive terms of the contract.

10.7.2 Encourage the Use of Alternative Data and Artificial Intelligence in Credit Underwriting

Regulators should continue to encourage the use of reliable alternative data and artificial intelligence underwriting techniques designed to expand credit offerings to traditionally underserved consumers. Data useful for cash-flow underwriting has been shown to be a particularly promising source of new information to promote financial inclusion beyond traditional credit reporting information. Potential new furnishers such as landlords, utilities, and others should be encouraged, where possible, to furnish information to credit reporting agencies. It is obvious that consumers with limited or nonexistent credit records are those who will benefit the most from using alternative data to underwrite credit offerings. The benefits of alternative data and artificial intelligence in promoting competition and innovation are discussed in Chapters 8 and 9 and it is not necessary to reprise those observations here. It is sufficient to observe for current purposes that allowing credit issuers to use alternative data to underwrite loan offerings can benefit consumers directly by allowing them to access products that they could not otherwise. There is now a voluminous body of research that identifies the substantial benefits to consumers from the use of alternative data, artificial intelligence, and other FinTech innovations in credit underwriting.[424] In addition, by issuing an initial loan that otherwise would not be made, the consumer can establish a payment history that, in time, will allow the consumer to build a traditional credit record.

In recent years, the credit scoring industry has continued to explore ways of enabling financial services providers to continue to expand access to more and more Americans. As discussed earlier, tens of millions of Americans lack credit scores completely or are "thin-file" consumers who lack sufficient information (or sufficiently recent information) to be able to be accurately scored. This problem substantially interferes with their ability to gain access to mainstream

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[424] For a recent thorough literature review of academic studies discussing the benefits to consumers from FinTech innovations, *see* Franklin Allen, Xian Gu, and Julapa Jagtiani, *A Survey of FinTech Research and Policy Discussion*, Federal Reserve Bank of Philadelphia Research Department Working Paper WP 20-21 (June 2020).

financial products. Creditors and credit reporting agencies have responded by developing new or improved credit scoring models that make use of alternative or non-traditional data, primarily data on recurring payments that are not captured in traditional credit-scoring models. Of particular interest has been to look to payments on obligations such as rent, utilities, and insurance premiums.[425] A 2012 study found dramatic increases in credit scores for thin-file consumers as a result of including utility and telephone payment data in their credit files. Twenty-five percent of thin-file consumers experienced an improvement in their credit scores while only six percent were downgraded. Low-income, minority, and those consumers who rent experienced the greatest positive effect from the inclusion of alternative data.[426] Underwriting models based on a consumer's cash-flow data also have been recognized as having particularly large potential to increase inclusion for many consumers.[427] Use of alternative data for credit underwriting purposes also received a dramatic boost during the COVID-19 pandemic when the flow of traditional credit reporting data was interrupted by various moratoriums on mortgage payments, other debt payments, collections, and other traditional indicia of credit risk.[428]

In one study, economists Julapa Jagtiani and Catharine Lemieux examined the use of alternative data to make loan decisions by the FinTech company LendingClub.[429] The authors found that over time LendingClub had increased its reliance on nontraditional alternative data relative to traditional FICO scores in making underwriting decisions while maintaining strong predictive loan performance in their portfolio. They also concluded "The use of alternative data has allowed some borrowers who would have been classified as subprime by traditional criteria to be slotted into 'better' loan grades, which allowed them to get lower-priced credit."[430] In a separate paper, the authors found that LendingClub's consumer lending activities penetrated areas that were underserved by traditional banks and which suffered from sub-optimal credit

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[425] Durkin, Et al., *supra* note 25, at 228.

[426] *See* Michael A. Turner, Patrick D. Walkder, Sukanya Chaudhuri, and Robin Varghese, A New Pathway to Financial Inclusion: Alternative Data, Credit Bullding and Responsible Lending in the Wake of the Great Recession (2012).

[427] *See* FinRegLab, The Use of Cash-Flow Data in Underwriting Credit: Empirical Research Findings (July 2019), *available in* https://finreglab.org/wp-content/uploads/2019/07/FRL_Research-Report_Final.pdf.

[428] FinRegLab, Data Diversification in Credit Underwriting: Research Brief (Oct. 2020).

[429] *See* Julapa Jagtiani and Catharine Lemieux, *The Roles of Alternative Data and Machine Learning in FinTech Lending: Evidence form the LendingClub Consumer Platform*, Federal Reserve Bank of Philadelphia Research Department Working Paper WP 18-15 (Jan. 2019) (finding increased reliance on nontraditional alternative data by FinTech lenders relative to traditional FICO scores and

[430] *Id.* at 12.

supply, such as those with highly concentrated markets and areas with fewer bank branches per capita.[431]

Use of traditional credit scoring for loan underwriting and pricing also appears to have a disparate impact on immigrants.[432] This appears to be because recent immigrants, regardless of age, lack sufficiently seasoned credit records[433] and as a result "resemble those of younger individuals, whose credit performance tends to be poor relative to the rest of the population."[434] According to a study by the Federal Reserve, these immigrant consumers are likely to benefit from greater use of nontraditional data such as rent, cash flow history, and recurring bill payments histories in their countries of origin could provide additional helpful information that would increase access for these consumers.[435] Financial regulators should examine and consider reforms that would make it easier for recent immigrants to gain access to financial services more readily.

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431 *See* Julapa Jagtiani and Catharine Lemieux, *Do FinTech Lenders Penetrate Areas That Are Underserved by Traditional Banks?*, Federal Reserve Bank of Philadelphia Research Department Working Paper WP 18-13 (Mar. 2018).

432 *See* Federal Reserve Board, Report to Congress, *supra* note 126, at 47.

433 *Id.* at p. S-5.

434 *Id.* at p. S-2.

435 *Id.*

11. Privacy and data security

In its discussion of credit information systems, the National Commission on Consumer Finance (NCCF) noted the issues surrounding privacy and the control of information systems, including specifically the need to consider carefully the tradeoffs often involved in protecting privacy. The concern at the time was the growing use of computers, and the NCCF noted that "protection against the invasion of privacy in the computer age must be achieved by balancing the need to preserve privacy against the desire to maximize benefits of efficiency inherent in the new technology."[1] In the internet age, it is clear that the benefits of new technology go far beyond greater efficiency in accomplishing old, familiar tasks, and include the creation of entirely new ways of satisfying consumer desires. Perhaps more so in financial services than in many other markets, the important benefits depend on the free flow of information. The NCCF concluded that "There must be no barrier to the prompt flow of adequate credit information into and out of the data base. *Any laws or action or inaction by industry that impede these flows also lower the availability of credit and raise its price to consumers."*[2] The Taskforce believes that conclusion is just as valid today as it was when the NCCF reached in in 1972.

This chapter considers the related issues of financial privacy and data security. We begin in Section I with a discussion of two fundamental economic factors that should shape approaches to privacy regulation, information asymmetry and the costs of conducting transactions. Section II considers the current disclosure-based approach to privacy regulation and argues that it is doomed to failure. In Section III, we lay out an approach to privacy regulation based on the consequences of information use and misuse, which considers both the benefits of information sharing and the potential costs, to privacy and otherwise. Section III also discusses a framework for analysis of information security issues and privacy issues in the context of credit reporting.

[1] Report of The National Commission on Consumer Finance, Consumer Credit in the United States 212 (Dec. 1972).

[2] Id. at 213.

11.1 Foundational Considerations

Many have argued that privacy is a matter of controlling the flow of information about an individual. Individuals want to choose what information they reveal, and to whom. On the other hand, providers of financial services in particular have a legitimate need for information about a consumer that the consumer might prefer not to reveal. This is the problem of information asymmetry: individual consumers may know more about the risks they pose than do providers of financial services. A second foundational issue is the costs of exercising control, which we consider in the topic of transaction cost economics.

11.1.1 Information asymmetry

A common concern in discussions about the cost of information is the problem of information asymmetry – one party to the potential transaction knows more about the deal than the other. Because information is costly, different parties, and different consumers, will have different amounts of information. The costs and benefits of acquiring information differ, so information disparities are inevitable.

In certain circumstances, information asymmetries can create problems in otherwise competitive markets. The best-known case is the market for "lemons."[3] Akerlof's conceptual example is the market for used cars. Sellers know whether the car they offer is high quality, and worth a high price, or low quality and therefore worth less. Buyers, however, cannot observe whether the product is high quality or low, but they are assumed to know the average quality of cars on the market. Market price will therefore reflect the average quality of traded goods. Sellers can profit by offering low quality goods at the high-quality price, which will reduce the average quality, reduce the market price, and reduce sellers' ability to offer high quality goods profitably. In the extreme, only low-quality goods are offered.

Fortunately, there is little or no evidence that any market has actually been destroyed by lemons market phenomenon. Nevertheless, some studies show that consumer inability to determine quality ex ante has detectable effects. For example, a recent study of the used car market found

[3] George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism,* 84 THE QUARTERLY JOURNAL OF ECONOMICS 488–500 (1970).

that trading for eight-year-old cars was delayed on average by about four months compared to what it would have been if quality had been fully observable.[4]

One factor limiting the emergence of lemons markets is the existence of quality assuring price premiums. Sellers who cheat by misrepresenting low quality goods as high quality will lose future sales. If there is a sufficient price premium for high quality, the potential loss of that premium by cheating motivates sellers to continue supplying high quality, because it is more profitable to do so in the long run.[5] In addition, as discussed in Chapter 7, investments in advertising and developing a good reputation create a bond that the firm will lose in the event of poor performance.[6]

Asymmetric information is important in credit markets, but it goes by a different name: adverse selection. Information is asymmetric because consumers have information about their likely ability and willingness to repay a loan that potential lenders cannot easily determine and may not be able to determine at all. The construction worker who seeks a loan to cover an income shortfall because of reduced hours likely knows whether the reduction was the result of bad weather or the employer's financial difficulties. The consumer with unexpected medical expenses inevitably knows more about the prognosis and the likely future consequences for income and expenses than does a potential lender.[7]

Of course, lenders can and do build sophisticated risk management models designed to predict the likelihood that a consumer will be both willing and able to repay a loan. By their nature, however, these tools are based on the performance of groups of individuals with a given set of characteristics. There remains variation within the group, where individuals have information about their own circumstances that creditors lack.

At a given interest rate, consumers who are more likely to default are also more willing to borrow at that interest rate. Moreover, the higher the interest rate, the greater the default risk of the consumers who are still willing to borrow. Lenders can observe the overall default rate in their portfolio, but they lack complete information on the risk that any individual borrower poses. If the default rate is higher than expected, lenders will raise their rates to cover the risk.

[4] Jonathan R. Peterson & Henry S. Schneider, *Adverse Selection in the Used-Car Market: Evidence from Purchase and Repair Patterns in the Consumer Expenditure Survey,* 45 RAND J. ECON. 140, 143 (2014). The effect for Hondas and Toyotas was smaller, around one month, than the effect for the American cars studied, the worst of which was about five months. *See id.* at 152 (Figure 3).

[5] Such a model is developed in Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance,* 89 JOURNAL OF POLITICAL ECONOMY 615-641 (1981).

[6] See Chapter 7, text accompanying notes 15-23.

[7] For a formal model of credit granting decisions with imperfect information, see Joseph E. Stiglitz and Andrew Weiss, *Credit Rationing in Markets with Imperfect Information,* 71 *American Economic Review* 393-410 (1981).

Unfortunately, a rate increase tends to drive out low risk borrowers, who are unwilling to pay the higher rate, and the default risk of the remaining customers increases. In the simple lemons model, low-quality goods drive out high-quality goods. In credit markets, high-risk borrowers drive out low-risk borrowers, potentially until only high-risk borrowers remain.[8]

Even if it does not destroy markets entirely, adverse selection creates real costs for consumers. In particular, the interest rate charged must be high enough to cover the average risk in the pool of borrowers. If lenders cannot distinguish based on risk, all will pay the same rate. Low risk borrowers are paying more for credit than their default risk would require, and high-risk borrowers are paying less than they should. Thus, low-risk borrowers effectively subsidize the higher risk borrowers.

One lender response to limit adverse selection is limiting the amount of credit extended. Because all consumers have limits on their ability to repay, larger loans involve a larger risk of default. Limiting loan size can therefore reduce the risk of default. Limiting loan size also limits the lender's potential losses in the event of default. The result, however, is that consumers cannot get as much credit as they want at prevailing interest rates, even though they are willing to pay for it. Moreover, some borrowers are denied credit, even though they are willing to pay for it.[9]

The response of credit markets to the coronavirus pandemic demonstrates exactly this problem. Under the Coronavirus Aid, Relief, and Economic Security Act, lenders who allow borrowers affected by the pandemic to defer payments cannot report to the consumer reporting agencies that the borrower is delinquent based on those payments. Deferrals have been given on over 100 million accounts. The result is that it is more difficult for lenders to identify risks, leaving no alternative but to cut back on credit extensions. In early April 2020, one third of banks reported that they had increased their minimum credit score requirements for credit cards. Mailed offerings of new credit cards and personal loans, and loan originations for credit cards, auto loans, and personal loans declined sharply through March, April, and May.[10] These changes may have been in part due to the expectation of generally increased risk, but information about who was actually affected would have limited the impact to those where the risk actually increased.

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[8] This discussion assumes that all consumers are offered the same price. As discussed below, risk-based pricing avoids this problem by differentiating consumers based on risk.

[9] Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, Consumer Credit and the American Economy 242 (2014).

[10] AnnaMaria Andriotis, Flying Blind Into a Credit Storm': Widespread Deferrals Mean Banks Can't Tell Who's Creditworthy, THE WALL STREET JOURNAL, July 8, 2020.

With less ability to identify risk, the likely result is less credit for broad portions of the population.

A different, and better, solution to the adverse selection problem is to reduce the information asymmetry that is the cause of the problem. That is the role of credit reporting agencies. By pooling information about past payment history, credit bureaus enable lenders to better separate potential borrowers based on the default risk they pose.

As credit reporting grew, it fostered the development of formal risk scoring systems, such as the familiar FICO score. Many creditors develop their own risk assessment models to take into account the particular characteristics of their products or customers. A 2004 study identified 70 different generic scoring systems that were available at the time, with more than 100 different scoring models.[11] Risk assessment models based on credit bureau data have been shown to outperform assessments based on application data in the context of credit card applications.[12] Some studies indicate that the delinquency risk when decisions are based on scoring algorithms from credit report data are 20 to 30 percent lower than the risk of delinquency when the lender uses "judgment" to decide which consumers deserve a loan.[13]

In turn, credit reporting and automated scoring systems enabled the emergence of risk-based pricing. Rather than charging all borrowers the same interest rate, risk-based pricing separates borrowers based on the likelihood of default. Borrowers who are better risks get lower rates than they would have to pay if all are charged the same rate. Higher risk borrowers are able to borrow, albeit at higher rates, when they likely would have been denied credit or received less credit under a one-price model.[14]

Risk-based pricing and the expanded reporting and automated risk assessment systems that made it possible have been an important enabling factor in the substantial expansion in credit discussed in an earlier chapter. It has also expanded access to credit for many consumers. In 1970, only 2 percent of households in the lowest income quintile had a bank type credit card. By 2001, 38 percent of the lowest income quintile had at least one bank type card, a level of

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11 Gary G. Chandler, *Generic and Customized Scoring Models: A Comparison*, in CREDIT SCORING FOR RISK MANAGERS: THE HANDBOOK FOR LENDERS, (Elizabeth Mays, Ed., 2004).

12 Gary G. Chandler and Lee E. Parker, *Predictive Value of Credit Bureau Reports*, 11 JOURNAL OF RETAIL BANKING 47 (1989).

13 Peter McCorkell, *The Impact of Credit Scoring and Automated Underwriting on Credit Availability*, in THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT (Thomas A. Durkin and Michael E. Staten, eds., 2002).

14 For an extended discussion of the benefits of sorting consumers by risk, see Michael Staten, *Risk-Based Pricing in Consumer Lending*, 11 J.L. ECON. & POL'Y 33 (2015).

ownership that persisted until the beginning of the financial crisis.[15] Moreover, risk-based pricing "led to a broader array of loan products available to all risk and income groups."[16]

Risk-based pricing obviously results in different prices for different consumers. That is both equitable and efficient, because it maximizes consumer welfare as collectively judged by consumers. A fundamental principle of economic efficiency is that those who create costs must pay them. If not, they will create excessive costs that impair economic performance. It is both equitable and efficient that teenage males pay higher auto insurance premiums than teenage females or older men – they are higher-risk drivers.

The same principles apply in credit markets. Some consumers manage their financial obligations responsibly and pay their bills on time. Others borrow more than they can afford, and in the end, default. Because default rates differ, it costs more to provide loans to some consumers than to others. In efficient markets, prices will reflect those cost differences, which also create incentives for higher risk borrowers to improve their financial performance. This arrangement is beneficial for both lower-risk and higher-risk borrowers. Low-risk borrowers get credit on better terms than they would pay if the lender is constrained to offer a single price and clearly benefit. There is no consumer protection reason that good credit risks should be expected to subsidize the choices made by those who are less likely to repay their debts.

The benefits to responsible, lower-risk borrowers were substantial as risk-based pricing emerged. The percentage of outstanding balances on credit cards with an APR greater than 18 percent fell from 70 percent in 1990 to 44 percent just four years later.[17] The lowest-risk customers enjoyed discounts of 8 percentage points on their APR.[18]

Higher-risk consumers also benefitted, from greater access to credit. A study of a subprime auto finance company that adopted risk-based pricing found that, for the lower-risk subprime borrowers, required down payments changed little, and loan size and car quality both

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[15] *See*, DURKIN ET AL., *supra* note 9, at Table 7.4, at 303. For all cards, 42.9 percent of those in the lowest income quintile had at least one card. Kathleen W. Johnson, Recent Developments in the Credit Card Market and the Financial Obligations Ratio, Federal Reserve Bulletin, Autumn 2005, at 475. As discussed in Chapter 10, the CARD Act has reduced card ownership among higher risk groups.

[16] *See* Wendy Edelberg, *Risk-Based Pricing of Interest Rates on Consumer Loans*, 53 JOURNAL OF MONETARY ECONOMICS 2283 (2006).

[17] *See* Staten, *supra* note 14, at 43.

[18] Mark J. Furletti, *Credit Card Pricing Developments and Their Disclosure*. Federal Reserve Bank of Philla Payment Cards Center Discussion Paper No. 03-02 (January 2003) Available at SSRN: https://ssrn.com/abstract=572585 or http://dx.doi.org/10.2139/ssrn.572585

increased.[19] Down payment requirements increased, however, for the highest risk group, resulting in smaller loans and lower default rates.[20]

Credit reporting is fundamentally an information system. It depends on the ability to share sensitive financial information without the consumer's consent, because allowing consumers a choice would significantly undermine the system's ability to assess risk. To be sure, credit reporting information is sensitive, and it should be protected. Since 1970, requirements have been in place under the Fair Credit Reporting Act requiring use of "reasonable procedures to assure maximum possible accuracy," and to restrict use of credit information to a specified list of permissible purposes. This is a fundamental privacy protection statute, but with a very different approach than what is currently in vogue, in, for example, the Gramm Leach Bliley Act (GLBA).

The Fair Credit Reporting Act has allowed expansion of credit reporting without significant restrictions on the categories of information that can be reported. Any information with a demonstrated relationship to the likelihood of repayment can generally be relevant and is permitted, as it should be. More and better information can enhance risk assessment and enable more efficient credit markets to the benefit of all consumers. "Flying blind" is not a solution.

11.1.2 Transaction Cost Economics

If privacy is seen as a matter of controlling the flow of information about an individual, the costs of exercising control are a key consideration. Transaction costs are important even when markets are perfectly competitive and consumers are fully informed, because the cost of engaging in a transaction may be too large to justify the transaction in the first place. If rearranging an investment portfolio would produce gains of a one percent higher return, but the costs of the rearrangement amount to 1.1 percent, engaging in the necessary transactions is simply not worth the cost.

Any transaction involves costs: Consumers must decide to pay attention to the decision, evaluate their alternatives, make a decision, and execute that decision. Transaction costs also include the costs of negotiating a deal in many instances. Some transaction costs are direct and explicit, as with the commission paid to a real estate agent or the fee for trading in a brokerage account. But

[19] Liran Einav et al., The Impact of Credit Scoring on Consumer Lending, 44 RAND J. ECON. 249 (2013)

[20] org/articles.php?doi=10.1257/mac.4.3.153. 33 William Adams et al., Liquidity Constraints and Imperfect Information in Subprime Lending, 99 AM. ECON. REV. 49 (2009).

all transactions have costs, which may preclude transactions that would make both parties better off if there were no transaction costs.

Many legal institutions essentially seek to reduce transaction costs. Despite the costs of administering and enforcing contracts, contract law that enables parties to make enforceable promises is much less costly than alternative means of assuring that a promise is kept. Although various market mechanisms create incentives for complying with contractual obligations,[21] in many instances contracts are not self-enforcing. When disputes arise between commercial parties, private contract enforcement generally provides adequate remedies. In consumer markets, however, the high costs of private enforcement may result in no effective remedy for practices that cause a small harm to a large number of individuals. In such cases, there is a critical role for government action to enforce consumer rights.

Much of contract law is designed to reduce transaction costs. For example, the law specifies default contract terms in certain circumstances. If these defaults are what most parties would prefer, they reduce transaction costs, because there is no need to negotiate over those terms. If they prefer otherwise, however, the parties can negotiate a different arrangement.[22]

In contracts, the parties are in contact with each other. Transaction costs are therefore likely to be relatively low in general, because the parties can negotiate.[23] In contrast, in other situations, transaction costs are quite high. There is, for example, no way for the parties who may eventually be involved in an auto accident to negotiate the terms of engagement when they meet at an intersection. Nor is there a practical way for consumers to negotiate the details of safe product design, whether it is for automobiles or toasters. Instead, tort law imposes duties on drivers regarding how they should behave and on manufacturers to avoid producing defective products.

The choice between contract and tort approaches to a particular problem is one in which transaction costs, relative to what is at stake, are crucial. If transaction costs are low, compared to the choice at issue, contract law is an appropriate approach, because it leaves the parties free to negotiate the arrangement that is best for them. When transaction costs are high, compared to the choice at issue, tort law and the imposition of legal duties is a more appropriate approach.

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[21] See Benjamin Klein. and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance,* 89 JOURNAL OF POLITICAL ECONOMY 615-641 (1981).

[22] This arrangement also imposes the transaction costs on the parties who benefit from them.

[23] With standard form contracts, "negotiation" takes the form of shopping elsewhere.

The stakes are high in an automobile accident case, but the transaction costs of negotiations to minimize the costs of accidents are even higher.

Substantive consumer protection requirements, such as restrictions on default remedies, are tort-like requirements imposing specific duties on sellers or lenders. They are appropriate where transaction costs significantly impair the ability to negotiate a contract. Because they do not allow alternative approaches, such requirements must be used with care to ensure that they create benefits that consumers value in excess of the potential costs of the restriction.

11.2 The Current Approach to Privacy Regulation

11.2.1 The Limitations of the Fair Information Practices[24]

When Congress adopted the privacy provisions of the GLBA, it adopted an approach to privacy that grew out of the Fair Information Practices ("FIPs) adopted in 1973[25] and is fundamentally rooted in disclosure. The starting point of FIPs is notice – consumers should be told what information is being collected about them and how it is being used. A second principle is choice; consumers should be able to control how information is used. Third, the access and correction principle states that consumers should be able to see information about them and correct any inaccuracies. Fourth, those who have consumer information must take steps to secure that information and protect it from unauthorized disclosure. Fifth, the onward transfer principle maintains that information should only be used for the purpose for which it was originally collected; additional information uses would require additional authorization from the consumer. There are other principles, but these are the most important ones.

Under GLBA, financial institutions must adopt privacy policies addressing their practices regarding information use and provide those policies to consumers. In theory, consumers will read the policies of their institution, compare them to the policies of competing financial services providers, and choose the institution with the privacy practices that best match their own privacy preferences. Under the statute consumers have a limited right to "opt out" of

[24] For a fuller discussion of the limitations of the Fair Information Practices, see J. Howard Beales, III & Timothy J. Muris, *Choice or Consequences: Protecting Privacy in Commercial Information*, 75 U. CHI. L. REV. 109 (2008).

[25] *Report of the Secretary's Advisory Committee on Automated Personal Data Systems*, US Department of Health, Education, and Welfare, Records, Computers, and the Rights of Citizens (1973), online at http://www.epic.org/privacy/hew1973report.

certain information sharing, primarily third-party marketing, but important information sharing for purposes such as credit reporting and fraud control is explicitly permitted without consent.

The FIPs approach as implemented in GLBA is at its heart a property rights approach to personal information. It regards personal information as the consumer's "property," although U.S. law has never considered it as such. It is a peculiar form of property, to say the least. You may regard your ZIP code as "yours," but it also likely belongs to tens of thousands of others. Nevertheless, under the property rights approach, consumers can theoretically control how this particular property is used.

From an economic perspective, information about interactions between consumers and companies is jointly produced, and not the result of either party's efforts alone. This is most apparent in a real estate transaction, where both parties know all of the relevant details of the transaction, and each has legitimate needs to use the information in various ways (not the least of which is filing taxes). There is no apparent reason why the information should "belong" to either the buyer or the seller alone, and no clear basis for deciding which should have control under a property rights approach.

There are substantial limits to the FIPs as an approach to privacy regulation. The concept of notice is simple enough, but the costs of actually using notices are out of all proportion to what might be at stake. A study of online privacy policies estimated that simply to read privacy policies on the websites a typical user encounters would take 244 hours – more than 10 days of around the clock reading. The estimated opportunity cost was $781 billion.[26] For most consumers, the issue is not worth thinking about, let alone the costs of considering the notices and making a decision. Moreover, a significant body of research finds that "consumers are comfortable with the type of data sharing involved in the day-to-day functioning of an ad-supported online world."[27] As a result, the default rule prevails. If the default is that information can be shared unless consumers opt out, the usual rule on internet sites, most consumers will allow sharing. If the default is opt in, however, most consumers will still do nothing, but sharing will not be allowed. Decisions about organ donation are analogous. Most consumers do not devote attention to considering the issue, and a study of European countries with different

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[26] Aleecia M. McDonald & Lorrie Faith Cranor, *The Cost of Reading Privacy Policies*, 4 I/S: J.L. & POL'Y 543, 544 (2008). Simplification is not an answer. Even in the highly unlikely event that we could reduce the time needed to read a privacy policy by half, five days of round the clock reading remains grossly disproportionate to what is at stake.

[27] James C. Cooper, and Joshua D. Wright, *The Missing Role of Economics in FTC Privacy Policy* (January 5, 2017). CAMBRIDGE HANDBOOK OF CONSUMER PRIVACY, (Jules Polonetsky, Evan Selinger & Omer Tene, eds., 2017), Available at SSRN: https://ssrn.com/abstract=2894438

default rules for organ donations finds that the default rule prevails.[28] In short, transaction costs leave the default rule in place, because few are willing to engage in the costs of making a decision.

As GLBA recognizes, choice must also be limited for certain information sharing. Credit reporting depends on the fact that consumers cannot choose not to have their financial performance reported. If they could choose, consumers with poor repayment histories would choose not to have their information shared, and the system would lose its ability to distinguish consumers based on risk – the asymmetric information problem would re-emerge. Similarly, the property recordation system, which enables potential lenders to determine whether there are liens or other claims against a particular property, depends on the absence of choice.

Allowing consumer access to the information can also be problematic, particularly if companies respond to requests for data without demanding sufficient identity verification. One researcher tested an experimental attack, with the co-author victim's consent, using only publicly available information about the victim to request access under the EU's General Data Protection Regulation's (GDPR) right of access. Requests were sent to 150 organizations with whom the victim might have had a relationship, but without knowing whether a relationship actually existed. No documents were falsified, but some legitimate documents were submitted with key information hidden. In the sample, 72 percent of the organizations handled the request, and approximately two thirds of them responded in a way that confirmed that a relationship existed with the victim, including an online dating service. Of those who had information, approximately one quarter provided information without verifying identity. An additional 15 percent requested easily falsifiable forms of identification, such as a signed statement swearing to be the subject. In all, there were 60 distinct instances in which information was obtained. The information included online dating profiles, previous addresses, detailed purchase histories, a complete record of all rail journeys over several years, all hotel stays with a particular chain, and a complete social security number. Various organizations provided portions of the victim's credit card information, so that at the end of the experiment the attacker knew 10 digits of the account number, the expiration data, the issuing bank, and the victim's postal code. A threat intelligence firm provided a list of previously breached user names and passwords, which worked on at least 10 online accounts, including an online banking service.[29] Clearly, access rights can create significant risks to consumers.

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[28] Eric J. Johnson & Daniel Goldstein, *Do Defaults Save Lives?*, 302 SCI. 1338 (2003)

[29] James Pavur and Casey Knerr, *GDPArrrrr: Using Privacy Laws to Steal Identities*, Blackhat USA 2019 Whitepaper, available at https://i.blackhat.com/USA-19/Thursday/us-19-Pavur-GDPArrrrr-Using-Privacy-Laws-To-Steal-Identities-wp.pdf.

Of course, those who possess consumer information can be encouraged, or required, to obtain better identifying information before granting access. That, however, may require the collection of more information about the consumer in order to ensure accurate identification. The fraud control tools discussed later in this chapter, for example, generally require detailed information about the consumer to determine the risk of a transaction, whether it is a financial transaction or a transaction granting access to a particular person.

Depending on its scope, the right to correct information can also pose risks. Obviously, consumers who are victims of fraud, for example, need to be able to correct their credit reports. Nonetheless, a separate database of information used in previous cases of known frauds reduces the risk that a person whose information was used is victimized again. The person with the greatest interest in "correcting" the information in the fraud database is the thief who used it and would like to use it again. Similarly, a database, separate from credit reports, of names and social security number combinations that have been used in previous instances of identity theft may be quite useful in preventing additional frauds. If one person's name was previously used in connection with a different person's social security number, however, from the point of view of either person, that record is a mistake. "Correcting" the information in the fraud database, however, undermines its value in reducing fraud.

11.2.2 Ambiguity about Consent

The premise of FIPs is that the consumer gives consent for certain uses of information. Often, however, the nature and scope of consent may be ambiguous. That has been the case in many of the Federal Trade Commission's (FTC) enforcement actions involving negative option plans, where consumers may not be aware they are signing up for a recurring transaction that will continue until cancelled. It was concerns about the adequacy of consent that led the FTC to require telemarketers to obtain the last four digits of the consumer's account number directly from the consumer when they already had the account number and the offer included a negative option feature.

The scope of consent was a source of concern in the early information aggregator models, which obtained access to the consumer's financial information by obtaining the account credentials such as username and password. That "consent" could lead to far broader access to an account than the consumer intended, with potential for adverse consequences. The development of an applications programming interface that gives more nuanced access to the needed information has greatly reduced this potential problem.

There is an inherent tradeoff between the quality and clarity of consent on the one hand, and convenience on the other. If each transaction in a series is separately authorized, there is less room to question that consent was given. But authorizing a repeated billing for a series of transactions, even when the details of those transactions are not yet specified, is far more convenient. Auto-shipped merchandise from Amazon or other retailers is far simpler and for many greatly preferable to placing each order separately. Certainly, few want to enter all of their credit card information every time they visit Amazon, although doing so reduces any possible ambiguity about consent. Even when the details of future transactions are unknown, as with a dry cleaner who picks up and delivers the laundry and processes the charges through a card on file, the convenience of not having a separate bill to deal with outweighs any uncertainty about what they have agreed to for many consumers.

Potential ambiguities about whether consent was given are likely to grow with the spread of radio-frequency identification (RFID) enabled devices connected to the internet, the so-called internet of things ("IoT"). Some have estimated there will be 31 billion IoT devices by the end of 2020.[30] A "smart" refrigerator that can prepare a shopping list when stocks run low would be a great convenience, without raising consent issues. But it would be even more convenient if the appliance could order needed goods and they would appear on your doorstep.[31] Clearly, a consumer must agree to this arrangement. It is not clear, however, that there is a practical way to grant consent for each individual transaction, leaving some ambiguity about whether any individual transaction was actually authorized.

11.2.3 Recent General Privacy Regulation and its Effects

Two privacy laws based on the property rights approach have recently taken effect. The European Union's General Data Protection Regulation ("GDPR") effective on May 25, 2018, has been in place long enough for some early assessments of its impact to have emerged. More recently the California Consumer Privacy Act ("CCPA") took effect on January 1, 2020, and enforcement began on July 1, 2020. Compliance with the GDPR was a major undertaking for companies that operate in the EU, as it is for the far more numerous U.S. companies that must comply with the CCPA. Although there are important differences, the two laws have fundamental similarities in their approach.

Of course, the GDPR requires notice of what information is collected and how it will be used. Data cannot be used for purposes that were not included in the original notice without obtaining additional consent. The notice must also include notice of the consumer's ("data subject") rights

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[30] Gilad David Maayan, *The IoT Rundown for 2020; Stats, Risks and Solutions,* SECURITY TODAY, Jan. 13, 2020 , available at https://securitytoday.com/articles/2020/01/13/the-iot-rundown-for-2020.aspx#:~:text=in%202018%e2%80%94there%20were%207.of%2031%20billion%20iot%20devices

[31] Avi Itzkovitch, *The Internet of Things and the Mythical Smart Fridge,* UX MAGAZINE, Sept. 18, 2013, available at https://uxmag.com/articles/the-internet-of-things-and-the-mythical-smart-fridge.

under the GDPR. With certain exceptions, controllers must obtain affirmative, informed and freely given consent to use personal data. This is, in essence, an opt-in requirement. Probably the most important exception is that if the consumer requests a specific action, such as placing an order, the controller can use the information to the extent necessary to complete that request. However given, consent for further use of the data can be withdrawn at any time. Consumers also have the specific right to object to the use of information for profiling, for direct marketing, or for research purposes. The GDPR includes data minimization requirements; data can only be used to the extent it is "necessary." Data subjects have the right to examine and correct the information a data controller holds about them. They also have the right to have information about them deleted and the right to data portability.

The CCPA has similar notice requirements, but with differences in the specific information required as well as the requirements for how notice is delivered. Consent under the CCPA, however, differs significantly. Affirmative informed consent is not generally required, but consumers have the right to opt out of the sale of information to third parties, with certain exceptions. Websites must include a clear and conspicuous "Do Not Sell my Personal Information" link on the home page. A consumer who opts out cannot be asked to reauthorize information use for 12 months. Opting out of the sale of information is the consumer's only option; there is no specific right to object to certain uses. CCPA's right of access and right to deletion is similar to the GDPR, but the CCPA provides broader grounds for a business to refuse to delete data. Unlike GDPR, CCPA has no right to correct or complete data. Data portability requirements are similar in the two regimes.

Because the GDPR became effective in 2018, studies of its impact have begun to emerge. Early studies find significant adverse effects. A study of venture capital financing of EU-based businesses found significant declines after GDPR took effect. Between May 2018 and April 2019, overall venture funding for EU tech firms fell $14.1 million per month per member state. The number of deals fell 26 percent, and the average amount raised per deal fell 34 percent. Effects were greater for "new" ventures (those three years old or less) and for businesses that were "more data-related." [32] A study based on data from Adobe Analytics, the number-four provider of data analytic services, found that recorded page views fell 9.7% and visits fell 9.9% after GDPR took effect. Among e-commerce sites, orders fell 5.6% and revenue fell 8.3%, or $8,000 per week for the median site. [33] The authors suggest that at least part of this decline was because of

[32] Jia, Jian and Jin, Ginger Zhe and Wagman, Liad, *The Short-Run Effects of GDPR on Technology Venture Investment*, SSRN (November 8, 2019). Available at SSRN: https://ssrn.com/abstract=3278912 or http://dx.doi.org/10.2139/ssrn.3278912.

[33] Goldberg, Samuel and Johnson, Garrett and Shriver, Scott, *Regulating Privacy Online: The Early Impact of the GDPR on European Web Traffic & E-Commerce Outcomes*, SSRN (July 17, 2019). Available at SSRN: https://ssrn.com/abstract=3421731 or http://dx.doi.org/10.2139/ssrn.3421731.

less effective marketing, because many visits follow clicking on a display ad or an email link. A study using data from an intermediary that collects consumer search queries and purchases across most major online travel agencies found a 12.5% decline in the number of consumers observed. In the context of auction markets for online search advertising, where advertisers bid for words included in the consumer's search to trigger their advertisement, the revenue loss was offset by the fact that the remaining consumers had higher value to advertisers, because their tracking history was longer.[34]

To date, all of the observed effects of GDPR are short run effects. Over time, firms will surely learn how best to live with the new regulatory regime, in ways that will likely attenuate its adverse impacts. Although the long run effects may be reduced, their elimination is unlikely. If there were better ways to market than the pre-GDPR approaches, firms had every reason to adopt them. The significant adverse effects to date strongly caution against modeling U.S. privacy regulation on the GDPR, and there is little reason to believe the effects of the CCPA will be significantly better.

11.2.4 The Competitive Consequences of Privacy Regulation

Data are the essential raw material of the information economy. In an economy that is increasingly driven by machine learning and artificial intelligence, access to data is the sine qua non of competitive advantage. Whether it is humans or machines seeking to extract knowledge from data, the data itself are key.

The quality of the knowledge that can be extracted depends on several characteristics of the underlying data. It depends on the volume of data; more information is generally better. Data variety is also important; diverse information sources likely increase the knowledge that can be gained. The veracity of data is critical; inaccurate or unreliable data are not likely to yield useful insights.[35] Finally, in many applications the freshness of data is important; stale data may generate "insights" that are no longer correct.[36]

Because data are valuable, companies that have data have an incentive to maintain control. Data that allow better assessment of credit risk, for example, may also allow competitors to identify

[34] Guy Aridor, Yeon-Koo Che, and Tobias Salz. *The Economic Consequences of Data Privacy Regulation: Empirical Evidence from GDPR*, NBER Working Paper No. 26900 (March 2020).

[35] A persistent problem in machine learning is that algorithms developed using biased data sets will likely faithfully reproduce the biases in the original data.

[36] *See* Michael S. Gal and Oshrit Aviv, *The Competitive Effects of the GDPR, Journal of Competition Law and Economics* (forthcoming, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3548444.

and target an institution's best customers. Major credit reporting agencies combat this incentive by requiring many institutions to contribute data as a condition for purchasing data or for purchasing data at a favorable price. Nonetheless, declining to share information has been an issue from time to time, as some furnishers have strategically withheld certain information.[37] A recent Consumer Financial Protection Bureau (Bureau or CFPB) report found that major credit card issuers were substantially less likely than other lenders to report actual payment amounts, and that issuers appear to either report actual payments for almost all or almost none of their accounts. Actual payments information may help to distinguish consumers who typically pay their balance in full from those who revolve their balance, an important consideration in card marketing.[38] Strategically withholding information generally impairs competition, and harms consumers.

Privacy concerns, real or imagined, offer another rationale for withholding valuable information to obtain competitive advantage. For example, Apple is planning changes to its iOS that will require additional consumer consent before apps can share the identifier for advertisers ("IDFA," also known as Mobile Ad ID or "MAID"), widely used in the advertising industry to identify a particular device for purposes of tracking browsing behavior and measuring advertising effectiveness. The change will reduce the competitive appeal of using advertising placed through Google, Facebook, and other non-Apple providers, who will have less information about the user to target advertising, and enhances the appeal of advertising purchase through Apple, which still has access to the data.[39] One industry participant thought there was "probably 30 percent truth in that they're doing it for privacy reasons, and it's 70 percent that they're doing it because it's what's good for Apple."[40]

Of course, companies can choose to compete based on their ability to satisfy consumers' privacy preferences, and doing so will benefit the company as well. That may be Apple's objective. Apple has also called for privacy regulation that would impair the ad-supported model of its key competitors far more than it would impact Apple's own subscription and sales-based model.[41]

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[37] For example, for a period of time Capital One was not reporting a customer's credit limit to credit reporting agencies, because it feared undercutting a proprietary risk management system that it saw as a business advantage. *See Lenders Faulted for Giving Incomplete Credit Picture,* LOS ANGELES TIMES, July 30, 2003.

[38] https://files.consumerfinance.gov/f/documents/cfpb_quarterly-consumer-credit-trends_report_2020-11.pdf

[39] John Koetsier, Apple Just Crippled IDFA, Sending an $80 Billion Industry Into Upheaval, FORBES, June 24, 2020.

[40] Nick Jordan, Founder of Narrative I/O, quoted in Reed Albergotti and Elizabeth Dwoskin, *Apple makes a privacy change, and Facebook and advertising companies cry foul,* THE WASHINGTON POST, August 28, 2020.

[41] Ian Bogost, *Apple's Empty Grandstanding About Privacy,* THE ATLANTIC, Jan. 31, 2019. https://www.theatlantic.com/technology/archive/2019/01/apples-hypocritical-defense-data-privacy/581680/.

Regulatory requirements based on claimed privacy concerns, however, rather than privacy preferences revealed in the marketplace, are an attempt to secure from government advantages that consumers are unwilling to bestow.

Similarly, privacy regulatory requirements can create artificial competitive advantages. By far the largest players in the online advertising marketplace are Google and Facebook, in large part because users sign in to use their services. Sign-in enables these companies to collect substantial amounts of information. Third-party competitors use tracking cookies to obtain much of the same information by building networks of website publishers, which allow these firms to obtain information about browsing at all sites in the network (and, by cross matching the cookies, about browsing on other networks as well). An early study after the GDPR went into effect found that there were significant declines in the number of websites that smaller vendors could observe, but that Google's reach increased.[42] Both Google and Facebook had revenue growth greater than the European digital advertising market growth, implying increases in their market share.[43] Researchers have also found that GDPR increased concentration among the technology vendors who provide services to websites.[44]

These adverse effects on competition arise for a number of reasons. First, theoretical work indicates that the transaction costs of obtaining user consent disproportionately affect smaller and more specialized firms, thus favoring firms that are both larger and provide a broader array of services.[45] Second, users of data are potentially liable under the GDPR for violations by the firm that collected the data, and firms may be more willing to trust the compliance efforts of large companies such as Google and Facebook than they are smaller vendors.[46] Third, there have been allegations that Google used an unnecessarily strict interpretations of GDPR to impose restrictions on its vendors and users of its advertising systems. Google's consent tool, for example, limited publishers to a maximum of 12 ad tech vendors, where many had previously

[42] Bjoern Greif, *Study: Google is the Biggest Beneficiary of the GDPR*, GHOSTERY.COM, October 10, 2018, available at https://www.ghostery.com/blog/ghostery-news/study-google-is-the-biggest-beneficiary-of-the-gdpr/.

[43] Nick Kostov and Sam Schechner, *GDPR Has Been a Boon for Google and Facebook,* THE WALL STREET JOURNAL, June 17, 2019.

[44] Johnson, Garrett and Shriver, Scott and Goldberg, Samuel, *Privacy & Market Concentration: Intended & Unintended Consequences of the GDPR*, SSRN, (July 8, 2020). Available at SSRN: https://ssrn.com/abstract=3477686 or http://dx.doi.org/10.2139/ssrn.3477686

[45] James David Campbell, Avi Goldfarb, and Catherine E. Tucker, *Privacy Regulation and Market Structure,* 24(1) JOURNAL OF ECONOMICS & MANAGEMENT STRATEGY 47 (2015).

[46] See Gal and Aviv, *supra* note 36.

used more.[47] Finally, consumers may simply be more willing to grant consent to well known, consumer-facing companies, and less likely to agree to share with the behind-the-scenes advertising technology companies that are almost universally unknown to consumers.[48]

Of course, privacy concerns may be legitimate. When information aggregators began offering their services by obtaining the consumer's credentials and essentially "scraping" information from the website of the financial service provider, they were circumventing the bank's security measures to provide their service to consumers. These concerns have been largely resolved by the development of an Application Programming Interface (API), which give information aggregators sanctioned access to the bank's information with proper consumer authorization. Banks were legitimately concerned, but they also stood potentially to benefit from protecting detailed information about their customers. When privacy concerns are raised as a rationale for restricting information sharing, regulators should evaluate not only the potential privacy benefits of any restrictions, but also consider the potential for adverse competitive consequences, which will inevitably harm consumers.

In significant part, the potential for anticompetitive consequences of privacy regulation stems from the distinction between "first parties," who collect information directly from consumers, and "third parties," with whom that information may be shared. First parties typically have broad permission to use the data as they see fit, but there may be numerous restrictions on sharing information with third parties.

There is no clear privacy difference between the two scenarios. Privacy problems would intensify, not disappear, if all information were collected by a single first party but never shared. Nor is it clear that sharing creates any new or unique privacy risks. When information is shared by granting access to a centralized data source, for example, there may not even be another copy of the information that could constitute another target for hackers. Instead, there is simply another access point in a network that likely has many such access points, with or without sharing. First parties and third parties alike may fail to take adequate steps to secure data, creating harm to consumers. Similarly, first parties or third parties may use information in ways that are harmful to consumers, but the concern is with the use, and not the fact of sharing. Regulatory burdens on sharing may simply increase the costs of obtaining the information needed to provide valuable services to consumers.

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47 https://www.adexchanger.com/online-advertising/googles-gdpr-consent-tool-will-limit-publishers-to-12-ad-tech-vendors/ (May 3, 2018). See also Jessica Davies, 'The Google Data Protection Regulation': CDPR is strafing ad sellers, Digiday (June 4 2018), available at https://digiday.com/media/google-data-protection-regulation-gdpr-strafing-ad-sellers/.

48 For example, the first four members of the Network Advertising Initiative, an industry self-regulatory group, are 33Across, Acuity, Adara, and Add This, none of which are household names.

The economic question is the most efficient way to organize the information economy in a way that allows each company to obtain the information necessary for competitive success. If a use of information by a "first party" is a useful practice that benefits consumers, it does not become any less useful, or create any more of a risk to privacy, if the most efficient way to produce those benefits is to share the information with a "third party" who actually does the analysis. Instead, the goal should be to maximize the ability of the cooperating parties to exploit their competitive strengths and minimize costs to consumers. Restrictions on sharing create incentives for "first parties" to collect more information than they might otherwise, rather than obtaining the information from some other party who can collect it more efficiently. Such restrictions may degrade the quantity and quality of information available and increase the costs of obtaining necessary information.[49] Neither outcome is good for consumers.

Restrictions on information sharing may also reduce the amount of information collected, again with the potential for adverse consequences for consumers. Lenders have an obvious incentive to screen potential borrowers to assess risk and deny loans to borrowers who are too risky. An additional incentive to screen borrowers, however, is the possibility of profiting from other uses of the information, such as marketing related services. If lenders cannot use the data for such purposes, they may collect less data in the first place. As a result, lenders will be less able to assess risk. To prevent increasing losses, they will deny more loans initially. In essence, rather than gathering more information to assess marginal applicants, they may simply deny credit, because gathering information is less valuable if it cannot be used for other purposes.

As noted above, the Federal GLBA established an opt-out rule for information sharing – institutions could share data unless consumers told them not to do so. In 2002, however, several local governments in the San Francisco Bay area adopted opt-in requirements, prohibiting further use of the data for marketing without the consumer's express consent. (California eventually adopted this approach statewide, effective in 2004.) With less incentive to gather information, denial rates for mortgage loan applications increased, for both purchases and refinancing, in jurisdictions that adopted opt-in requirements compared to those who did not. Moreover, as the financial crisis began to unfold in 2007 and 2008, foreclosure initiation rates were higher in counties with the opt-in requirement.[50]

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[49] See Gal and Aviv, *supra* note 36, for a discussion of the potential impacts of privacy regulation on industrial organization and the choice between internal collection and sharing.

[50] Jin-Hyuk Kim and Liad Wagman, Screening incentives and privacy protection in financial markets: a theoretical and empirical analysis, 46 RAND J. ECON. 1-22 (2015).

11.3 Privacy Regulations Should Reduce Harms by Focusing on the Consequences of Information Use

11.3.1 Regulation Based on Consequences

The first Federal privacy statute was the Fair Credit Reporting Act, passed in 1970. It established a regulatory scheme to govern the credit reporting industry that has stood the test of time (albeit with numerous amendments along the way) and preserved and expanded an important information source for financial services firms.

Although the statute includes elements of the fair information practices principles, it takes a very different approach to privacy regulation than does the GDPR or the CCPA. Most prominently, it allows information sharing without the consumer's consent, which, as discussed above, is an essential element of the credit reporting system. Instead, it restricts the uses of credit reports to a narrow list of permissible purposes. Moreover, it directly addresses a principal source of adverse consequences of credit reporting for consumers, requiring "reasonable procedures to assure maximum possible accuracy." Allowing consumers access to their credit reports, providing notice when a credit report is the basis for an adverse action, and allowing consumers to dispute information in their report are other important elements to ensure credit reporting information is accurate. But the focus is on the problem of ensuring accuracy, not the process by which information is initially gathered.

The privacy policies that are the foundation of the current approach to privacy regulation are surely the epitome of information overload, discussed in Chapter 7. Rather than protecting consumers from possible problems, they rely on consumers to read and understand legalistic descriptions of the complex, technical information flows that are central to the information economy – and then take steps to protect themselves. It is, in essence, a contract-based approach to privacy, with the parties theoretically bargaining about what information practices are acceptable. Applied to automobiles, this approach would let manufacturers produce any car they wished, as long as they disclosed all of the technical specifications. This is not consumer protection; it is caveat emptor in the extreme.

Rather than relying on a contractual approach to privacy, an approach based on tort law would be more protective of both privacy and consumers. The risk of potential privacy problems such as data security breaches are relatively remote in time and likelihood when consumers are selecting a provider, which suggests that consumers may have little reason to consider them carefully. The problem is similar to products liability, in which consumers are unlikely to invest in information about the benefits and costs of a relatively remote risk of a serious product failure.[51] Imposing tort liability on product manufacturers is a more sensible solution.

Applied to privacy, a tort approach would impose substantive regulation on holders and/or users of information to prevent harm to consumers. A consequences-based approach to privacy regulation leads immediately to the relevant question: what is the impact of a particular use of information on consumers? The reason we care about commercial information use or sharing is that something bad might happen to consumers, and the goal should be to avoid those adverse consequences. There is little reason for concern when using information benefits consumers, as it does when information is used to process a transaction or when information collected for a different purpose is used to reduce the risk of fraudulent transactions. There are legitimate concerns when information is used in ways that harm consumers, but the focus should be on controlling harmful uses of information, rather than trying to control the information itself. Regulation should seek to protect consumers, rather than protecting data.

Harms may be economic, as with identity theft or inaccurate information in credit reports. In some instances, harms may be physical, and relatively small disruptions to large numbers of consumers may constitute an actionable harm. Harms certainly include the recognized privacy torts of harm to reputation, intrusion on a private place, or spreading intimate details before the public, which all require conduct that "would be highly offensive to a reasonable person."[52]

Of course, some consumers may want privacy protection that goes beyond preventing concrete harms. In many instances, those concerns have not been articulated with any specificity, making policies to reduce the harm very difficult to develop. Moreover, specific concerns may vary widely from person to person, again making a regulatory response difficult. Some, for example, may simply consider certain uses of information "creepy," as with Target's algorithm used to identify pregnant women for marketing purposes based on their other purchases.[53] Others may greatly value the discounts for newly-relevant products that resulted from the use of the information. Because no company wants to offend its customers, Target adjusted its marketing practices to reduce consumer unease, but continued to use the algorithm. The ability to opt out of certain information uses or information sharing allows those with particularized privacy preferences to protect them, without imposing significant costs on those who do not share their

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[51] See RICHARD POSNER, ECONOMIC ANALYSIS OF LAW, Section 6.6 (2014).

[52] Restatement (Second) of Torts § 652B (1977) (intrusion upon seclusion); id. § 652D (publicity given to private life); id. § 652E (publicity placing person in false light).

[53] See Kashmir Hill, *How Target Figured Out A Teen Girl Was Pregnant Before Her Father Did,* FORBES, Feb. 16, 2012. Available at https://www.forbes.com/sites/kashmirhill/2012/02/16/how-target-figured-out-a-teen-girl-was-pregnant-before-her-father-did/#1992aa3b6668.

concerns. It is therefore a valuable safeguard for those with possible intense, but idiosyncratic preferences.

Privacy harms do not depend on the consumer's state of residence. They are the same, wherever the consumer lives. There is therefore little benefit in allowing states to customize their privacy requirements. There are, however, significant costs, particularly for online commerce, if companies must comply with a patchwork of inconsistent requirements. Like the Fair Credit Reporting Act, the central provisions of a federal privacy law should be preemptive. That is especially so because sharing information about, for example, California consumers may allow the development of better tools for important functions that benefit consumers in Massachusetts as well.

Data breach notification laws are a case in point. All 50 states have such laws, plus the District of Columbia, Guam, Puerto Rico, and the Virgin Islands.[54] States differ in what information is considered protected and in the entities who must give notice. "State laws differ not only in the types of data breaches they regulate, but also in who, what, when, and how they require companies to notify their customers."[55] States also have differing "triggers" for when a breach must be disclosed, such as when unauthorized "acquisition" occurs, or unauthorized "access," or either access or acquisition. The need to understand and apply these various requirements raises obvious compliance difficulties for a national organization, with little obvious benefit to consumers. Nor is the objective of breach notification laws clearly specified. If the objective is to provide actionable information for consumers, the scope of breaches that require disclosure should be limited to ones where there is some step consumers should take to reduce their risk; in many cases, there are no such steps and notice serves little purpose. Broader disclosure runs the considerable risk that consumers will simply ignore all breach notifications, even when action is necessary. If the objective is public shaming of companies with inadequate security, far less costly public notice requirements could likely achieve the goal with lower compliance costs. In any event, there should be a uniform national standard that applies. To the extent that state laws have allowed experiments with different approaches, it is time for Congress to learn what can be learned from the experiments, and discard the experiments that failed.

Beginning in 2001, the FTC has used its authority to prohibit unfair or deceptive acts or practices to build a productive privacy protection program based on the consequences of

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[54] National Conference of State Legislatures, *Security Breach Notification Laws.* Available at https://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx.

[55] Mark L. Krotoski, Lucy Wang, and Jennifer S. Rosen, *The Need to Repair the Complex, Cumbersome, Costly Data Breach Notification Maze, Privacy & Security Law Report,* 15 PVLR 271, 2/8/16, available at https://www.morganlewis.com/~/media/files/publication/outside%20publication/article/bna-need-to-repair-data-breach-notification-maze-08feb16.ashx.

information use and misuse. This approach led directly to the National Do Not Call Registry, and to the FTC's information security cases. The FCRA is an example of this approach, imposing duties on credit reporting agencies to limit the uses of information and to ensure its accuracy. The resolution of privacy concerns about information aggregators through the development of an API is a non-regulatory example of the same principle: privacy requirements should seek to provide real protection from real problems, rather than relying on an obscure disclosure that some risk exists.

11.3.2 Benefits of Information Sharing

A substantive approach to privacy regulation must consider the costs and benefits of the uses of shared information. Some benefits are clear and straightforward; others are far more difficult to identify or quantify. For example, sharing information allows personalization and customization of websites to increase convenience and ease of use for consumers. That is an essential part of the business of information aggregators, which allow consumers to display information from a number of different financial service providers in a single display and format.

One clear example of the benefits of information sharing is the credit reporting system, discussed above. The system enables better management of risk and extensions of credit to consumers who might otherwise be denied credit entirely.

Much of the internet content we all enjoy, and many valuable services such as email, cloud storage, and software, are "free" because they are supported by advertising. The revenue available from advertising in turn depends on information about the potential customer. A study of the effects of the EU's 2002 E-Privacy Directive found that reduced ability to target advertising reduced advertising effectiveness by 65%.[56] A study of auction markets for online advertising in the U.S. found that if a cookie was available with an impression, the price was roughly three times higher than if there was no cookie.[57] More recently, the UK's Competition and Marketing Authority on Online Platforms and Digital Advertising concluded that blocking third-party cookies would reduce short-run publisher revenue by 70 percent.[58]

[56] Avi Goldfarb and Catherine Tucker, *Privacy Regulation and Online Advertising,* 57(1) MANAGEMENT SCIENCE (2011), 51-71.

[57] J. Howard Beales and Jeffrey A. Eisenach, *An Empirical Analysis of the Value of Information Sharing in the Market for Online Content,* published online by Digital Advertising Alliance, available at http://www.aboutads.info/resource/fullvalueinfostudy.pdf, January, 2014.

[58] COMPETITION & MARKETING AUTHORITY, FINAL REPORT ON ONLINE PLATFORMS AND DIGITAL ADVERTISING, Appendix F, at paragraphs 115-120 (July 1, 2020).

Paradoxically, one crucial tool in the fight against fraud of all sorts and identity theft in particular is the ability to share sensitive information. Controlling identity theft requires that the company considering an extension of credit have access to more information about the real person than the thief. That allows the company to determine whether the transaction is likely legitimate or fraudulent.

Given the information available, any attempt to detect and prevent fraud confronts an inherent tradeoff between false positives and false negatives. False positives occur when a potential transaction is mistakenly identified as potentially fraudulent. Consumers are likely to be contacted for additional information, and their transaction may be delayed. False negatives occur when fraudulent transactions are mistakenly approved. Merchants or financial institutions suffer financial losses, and consumers may find themselves victims of identity theft. The only way to reduce both false positives and false negatives is to obtain more and better information, which is the key to better predictions of the risk of fraud.

A wide variety of information-based products help financial institutions and others identify, and in some cases quantify, the risk that a proposed transaction is fraudulent. The most straightforward such tool is fraud data bases, which identify information that has been used in past fraudulent transactions. The Postal Service, for example, maintains a list of addresses that have been used in previous mail fraud cases. Other databases allow identification of addresses that are campgrounds or telephone numbers that are in prisons.

More sophisticated tools look for consistency in the way information is used across different transactions. Often, these products use information that was collected for completely different purposes. Magazine subscription lists, for example, can help to identify an unusual combination of a name and address that may indicate increased risk that an application is fraudulent. Data on other transactions can similarly be used to check for consistency. Essentially, these tools use information from multiple sources to triangulate on the likelihood that a consumer is in fact who they claim to be.

Some products use information about past frauds to convert observed inconsistencies into a quantitative index of the risk of fraud, similar to credit scoring models. Still other approaches pool information from applications to search for unusual patterns across applications that may indicate fraud. For example, multiple applications in a short period of time listing the same workplace and telephone number may indicate that something is amiss.

Generally, these tools are used as the basis for requesting additional identifying information, rather than simply refusing the transaction. Users must develop their own criteria to balance the risk of false positives and false negatives. False positives may be particularly costly to the entity using the tool, because they will often trigger the need to request and process additional information.

Fraud control tools are only one example of benefits from secondary uses of information originally collected for a different purpose. Credit reporting itself is a secondary use of information; financial institutions maintain records of payment histories for their own business reasons, not for purposes of credit reporting. Strict application of the notice and choice approach to privacy regulation, however, frowns upon secondary uses unless they were disclosed at the time the information was originally collected. In some instances, this may not be possible, because the secondary use may have been discovered later.

We all benefit from many secondary uses of information. Location information that is used to monitor traffic patterns is a clear and familiar example. Using the same information to measure the extent of compliance with lockdown orders during a pandemic is another, more recent example. It is difficult to see a significant risk of harm in these instances. Using location data to locate a particular individual in real time is far more problematic, but that use of information can be specifically restricted, as can government access to the data.

Secondary uses of data are likely to grow with the expansion of the internet of things. As more and more devices are connected to the internet and communicate data relevant to their function to various entities, it seems almost inevitable that clever entrepreneurs will discover other insights that can be gleaned from the data, in ways that are almost impossible to predict. Machine learning and artificial intelligence almost always benefit from additional data, regardless of the original purpose for which it was collected. The growing use of these technologies will inevitably spur continuing searches for useful data.

There are, of course, risks in sharing information as well. Foremost among them is the risk that data will be compromised and used in ways that facilitate frauds than harm consumers. The task of sensible privacy regulation is to identify the potential harms and determine which solutions can best reduce the harm without compromising important benefits of information sharing.

11.3.3 Information Security

One clear duty of those who hold consumer information is to protect it from data breaches. Financial regulators have adopted rules requiring information security pursuant to the GLBA, and the FTC has a long series of cases contending that the failure to take security measures that are reasonable and appropriate under the circumstances is either a deceptive practice (if security claims are made) or an unfair practice.

Regulatory approaches to information security have been principles-based, rather than imposing specific requirements such as encryption or use of a particular technology. That approach is appropriate, because the security landscape is constantly evolving. The FTC's Safeguards Rule, for example, requires companies to assess the risks they face, take steps to reduce those risks that are reasonable and appropriate given both the size and sophistication of the business and the sensitivity of the information, monitor the environment both to identify new risks and assure the continued effectiveness of its program, and to adjust its security measures as necessary.

Information security choices necessarily involve tradeoffs, whether it is efforts to prevent fraudulent transactions or to protect stored information. If a fraud control system mistakenly declines a transaction, the costs fall on the consumer who initiated it. Those costs depend on the nature of the transaction. In an application, it may just be the need to provide additional information; in a credit card transaction, the consumer may be able to use a different card; in a debit card transaction the consumer may have no alternative but to abandon the attempted purchase. If a transaction is mistakenly approved, on the other hand, the costs most likely fall on the financial institution eventually, although sometimes significant costs may be imposed on consumers to restore their prior position, as in the case of identity theft. Users of fraud control systems must balance these potential costs.

As noted above, given the information available, there is no way to reduce the risk of both types of mistakes. Additional information, however, can enable better predictions, and simultaneously reduce both types of errors. Unnecessary restrictions on information sharing can make the task of obtaining additional information more difficult.

Another important tradeoff for consumers is between convenience and security. Convenience in a transaction is another way of saying transaction costs are low – there are not significant obstacles to engaging in the transaction. When a website stores a consumer's credit card information for use in future transactions, it reduces transaction costs for the consumer. It also creates, however, a potential security risk if the website is compromised. Entering a credit card number for each separate transaction is likely safer, but the gain in security may not be worth the loss of convenience.

An example of the tradeoff is the introduction of the EMV (Europay, Mastercard, and Visa) chip system in U.S. payment cards that began in 2015. Chips assign a transaction-specific identifier to each transaction, rather than using just the card number itself, thus substantially reduce the risk of counterfeit card transactions and therefore reducing the risk of fraud. On the other hand, payment systems impose transaction costs (often called "friction" in payment discussions), including the time it takes to complete the transaction. The goal of the system is to minimize total costs, i.e., fraud losses plus friction costs, which is the security vs. convenience tradeoff discussed above.

When chipped cards were introduced in the UK and the EU (earlier than in the US), they required the customer to enter a PIN for an added layer of security, but the US rollout of the system did not require a PIN. The reason is the tradeoff between avoided fraud losses and frictions in the system. In Europe, telecommunications systems have historically been slower and more expensive than in the US, and as a result, a transaction might not be approved or rejected until after the fact. The US system, however, enabled essentially real-time authorization of the transaction. In Europe, the additional fraud losses prevented by the PIIN, at the cost of some increase in frictions, made the PIN worthwhile. In the US, the additional fraud that a PIN might prevent was smaller, because of real-time approval, and the added frictions of requiring a consumer to enter a PIN would effectively increase the total cost of the system.[59] This was an efficient market outcome, rather than a market failure.

Similarly, two factor authentication is more secure than a single password to protect an account, but it is also less convenient. Again, companies (and policy makers) must balance these costs to determine the appropriate balance. One interesting possibility for improving the tradeoff for both parties is sharing additional information. For example, if a financial institution had access to cell phone location information, it could potentially verify that the user's cell phone was at the same location as the proposed transaction. Such a system may provide almost as much additional security as texting an authorization code to the phone, without the need for the consumer to take additional steps.

The current approaches to data security are essentially a fortress approach: build additional walls and barriers to block unauthorized entry into data systems. Unfortunately, any fortress can be breached, and determined attackers have clear motives for attempting to do so. Because breaches are inevitable, systems to minimize the costs of breach are also critical. Credit card numbers, for example, are frequently compromised, but the costs to consumers are generally low, because robust fraud detection systems are in place. Indeed, many consumers find out that their account has been compromised when the issuer calls to verify a suspicious transaction.

The inevitability of breach also means that the regulatory focus must be on reasonable measures, rather than imposing strict liability for any breach. Companies should be held accountable for failure to take reasonable and appropriate security measures, but even the best security efforts may be breached. When breaches occur, companies should learn from their

[59] See James Cooper & Todd Zywicki, A Chip off the Old Block or a New Direction for Payment Card Security: The Law and Economics of the U.S. Transition to EMV, 2018 MICH. St. L. REV. 869 (2018), for a fuller discussion.

mistakes, and share that information with others, to secure the particular door to the fortress that was pried open.

11.3.4 Privacy and Credit Reporting

As discussed above, credit reporting is vital to ensuring credit availability to as many consumers as possible on the best possible terms. We address two important privacy-related issues with credit reporting. First, we consider accuracy in credit reporting, because inaccuracies can create significant consumer harms. Second, we consider the use of alternative data, which can help expand credit access.

Accuracy in Credit Reporting

There are clear market incentives for credit reporting agencies to strive for accuracy. Accurate data are far more likely to offer reliable predictions of risk, which is why the market for credit reports exists in the first place. The FTC has noted that there are "market incentives to maintain and improve the accuracy and completeness"[60] of credit reports. Similarly, researchers at the Federal Reserve Board have said that "research and creditor experience has consistently indicated that credit reporting company information ... generally provides an effective measure of the relative risk posed by prospective borrowers."[61]

Market incentives alone, however, are not enough, and as discussed above, credit reporting is governed by the Fair Credit Reporting Act, which requires reasonable procedures to ensure maximum possible accuracy in reporting. The law also imposes obligations on those who furnish information to credit reporting agencies ("furnishers"). It also requires notice to consumers when credit report information results in an adverse action, and allows consumers to dispute information in their file. All of these requirements are aimed at ensuring accuracy of credit report information.

Credit reporting agencies face a difficult task of matching incoming information to the right file. Names may appear differently in different accounts, initials may replace names or vice versa, and names may change over time, sometimes repeatedly. Although mobility has declined over time, addresses change with much greater frequency than names; an average of more than 35 million people move each year.[62] Social Security Numbers (SSN) are subject to transposition

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[60] FTC Report to Congress under Sections 318 and 319 of the FACT Act of 2003, at 7 (December 2004).

[61] Robert B. Avery, Paul S. Calem, and Glenn B Canner, *An Overview of Consumer Data and Credit Reporting,* at 51-52, FEDERAL RESERVE BULLETIN (2003), available at https://www.federalreserve.gov/pubs/bulletin/2003/0203lead.pdf.

[62] Average of U.S. Census data since 2010.

and other errors, which are difficult to detect because, unlike credit card numbers, the SSN does not include a checksum digit. When information is withheld for privacy reasons, such as using only the last four digits of a SSN, the risk of mismatch increases. The lack of SSNs in many public records has been a particular problem in matching potentially important risk information to the right consumer. The risk of a mistake also depends on the quality of the information voluntarily provided by data furnishers. Even the best matching algorithms cannot overcome bad data.

It is obviously a mistake to include information in a consumer's file that is not in fact about that consumer. Moreover, even information that is included in the right file may be in error. These are the kinds of inaccuracies that most studies of credit report accuracy have examined.

The most reliable study of accuracy, released by the FTC in 2012, used guided consumer reviews of their credit reports and submitted any identified errors through the dispute resolution process. The study identified potential inaccuracies in 24 percent of credit reports, but only 6.6 percent of consumers saw their credit score change after going through the dispute process. In two percent of the files, credit scores rose by 25 points or more after disputes were resolved.[63]

There have been significant changes in the industry since the FTC study that should have improved credit report accuracy. Potentially the most important of those changes is the initiation of supervisory examinations by the CFPB. The Bureau's 2017 Special Issue of Supervisory Highlights focused on credit reporting, and identified the many changes the Bureau directed to improve accuracy, including increased oversight of furnishers and monitoring of dispute metrics to identify the root causes of disputes. The Bureau has also examined furnishers, and enforced obligations to review consumer disputes, including any relevant information provided by the consumer.[64] In addition, the national credit reporting agencies (CRAs) reached an agreement with state Attorneys General to make various improvements in accuracy, including establishing a National Consumer Assistance Program (NCAP) to facilitate error correction and improve accuracy.[65]

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[63] FTC, Report to Congress under Section 319 of the Fair and Accurate Credit Transactions Act of 2003 (December, 2012), available at https://www.ftc.gov/sites/default/files/documents/reports/section-319-fair-and-accurate-credit-transactions-act-2003-fifth-interim-federal-trade-commission/130211factareport.pdf.

[64] CFPB, SUPERVISORY HIGHLIGHTS; CONSUMER REPORTING SPECIAL EDITION (2017) https://files.consumerfinance.gov/f/documents/201703_cfpb_Supervisory-Highlights-Consumer-Reporting-Special-Edition.pdf

[65] Ohio Attorney General, Press Release, Matter of Equifax Information Services LLC, Experian Information Solutions, Inc., and TransUnion LLC 2015, https://www.ohioattorneygeneral.gov/Files/Briefing-Room/News-Releases/Consumer-Protection/2015-05-20-CRAs-AVC.aspx.

Have these steps, which on their face seem reasonable, actually worked to improve accuracy? We do not know. The most effective way to find out would be to conduct another study like the 2012 FTC study, designed in such a way as to allow comparisons to the earlier results. Such a study is unlikely to tease out the effects of particular improvements, but it can tell us about the current state of accuracy of credit reports. The consumer-focused methodology would also offer an opportunity to study consumer experiences and satisfaction with the dispute resolution process.

The Bureau should also seek to study a more subtle error in credit reports: the failure to include information that in fact should be part of a consumer file. Such errors of omission reduce the value of credit reports to lenders, because a report that does not include all of the relevant information about a particular consumer is less likely to be predictive of future behavior. In some cases, the failure to include relevant information may leave a consumer with a thin file and limited access to conventional credit, as discussed in more detail in the following section.

One regulatory change that would allow an empirical assessment of the tradeoff between errors that result from mistakenly including information and errors from mistakenly excluding information is the impact of the NCAP provisions requiring a minimum amount of identifying information (name, address, SSN and/or date of birth) before public record information is included in a credit report. When the agreement took effect, the Bureau found civil judgments, previously the most common public record in credit reports, disappeared, and tax liens fell by almost half.[66] The consumer-focused approach of the FTC accuracy study could potentially address whether the removals were in fact accurate. Moreover, as the Bureau noted in 2018, it could not assess the impact of the change on the predictiveness of credit scoring models, because it lacked the two years of data that is the standard time for evaluating such models. Sufficient time has now elapsed to conduct such an assessment and evaluate empirically the tradeoff between different types of mistakes. Such data could also be useful as the Bureau considers the use of alternative data in credit scoring, where concerns about ambiguity in matching information may loom particularly large.

The Bureau should also seek to study the problem of "file fragments" more broadly. File fragments result when incoming information cannot be matched with sufficient certainty for inclusion in a particular consumer file. The failure to include accurate information is an error in any credit report, but it is of particular concern when the result is a "thin file" – a credit report with insufficient data to determine a credit score.

[66] CFPB, Public Records, Quarterly Consumer Credit Trends (February 2018).

Alternative Data

Many consumers have insufficient data in their credit report to generate a score in typical credit scoring models. The Bureau has estimated that 26 million consumers are "credit invisibles," with no records with the national CRAs, and additional 19.5 million have records that either have too few accounts or accounts that are too stale to score.[67] The result is often an inability to qualify for mainstream credit, leaving only high cost alternatives. The thin file problem disproportionately affects the young (more than 80 percent of 18 and 19 year olds), Blacks and Hispanics (28 percent of each group, versus 16 percent for Whites), and lower income consumers (45 percent of the lowest income group, versus 8 percent of the highest).

Use of data not traditionally included in credit reports can reduce the incidence of thin files and increase credit availability for underserved populations. Studies have shown that adding positive payment information from utilities and telecommunications providers, in addition to the negative information that most now report, can improve the credit scores of those with thin files that otherwise do not have sufficient information to support a reliable credit score.[68] Most recently, a HUD-sponsored study found that reporting rent payments of HUD-assisted families would increase the number of these families with credit scores above 620 by 54 to 65 percent.[69] Such additional information can help to further reduce differences in the accessibility of credit on reasonable terms.

Although the credit reporting system is voluntary, pressure from regulators has ensured that most financial institutions share payment data with the national CRAs. That is not the case for numerous other users of credit reports, including wireless carriers, energy utilities, and media companies such as cable TV, broadband internet service providers, and landline telephone companies.[70] Moreover, when such companies report, they often report only derogatory information, rather than reporting the consumer's full payment history. In effect, they use credit reporting to gain leverage in collecting payments by threatening a bad credit report, but do not allow creditors to assess those negatives in the context of the consumer's full payment history,

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[67] The CFPB Office of Research, *Data Point: Credit Invisibles*, 16 (2015) (https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf)

[68] Michael A. Turner and Amita Agarwal, *Using non-traditional data for underwriting loans to thin-file borrowers: Evidence, tips and precautions*, 1 JOURNAL OF RISK MANAGEMENT IN FINANCIAL INSTITUTIONS 165 (2008). The Policy and Economic Research Council (PERC) has been researching such alternative data uses for a number of years. Its work is summarized in *Alternative Data Initiative: Report & Study Summaries* (May 2020), available at https://www.perc.net/publications/alternative-data-initiative-report-study-summaries/.

[69] HUD, *New Report Explores Problem of Credit Availability Among HUD-Assisted Households* (2020). https://www.hud.gov/press/press_releases_media_advisories/HUD_No_20_030

[70] See Comments of PERC on the December 10, 2019 Accuracy in Consumer Reporting Workshop, January 31, 2020.

and do not allow consumers credit for the larger number who pay their bills on time. Some have even argued that such companies should be required to report full file information.[71]

Given the wide diversity of potentially covered entities, the Taskforce does not endorse mandatory reporting. We believe, however, that Congress should clarify that, regardless of other privacy laws, any entity other than a health care provider with a consumer account that requires regular payments can share payment histories for the purpose of credit reporting. Moreover, state and local regulators should encourage entities subject to their jurisdiction to report full-file information, particularly when those entities report derogatory information. These practices are examples of "laws or action or inaction by industry" that impede the flow of credit information, and also "lower the availability of credit and raise its price to consumers."[72]

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[71] Id.

[72] NCCF (1972), *supra* note 1, at 213.

12. Consumer empowerment: Financial literacy, trends for young people, savings, and retirement

This chapter turns to the topic of consumer empowerment both in general as it applies for all consumers, through consumer financial education, and as it applies to the unique challenges of two specific demographic groups, younger consumers and older consumers.

"Empowerment," is a general theme of this entire report, especially as it relates to competition, innovation, and financial inclusion. During the last century, most of the basic framework of analysis has been developed consumer finance economists and many of the fundamental elements of consumer finance economics and consumer financial protection policy have been established. As noted, this report has been actuated by the same basic themes that motivated the National Commission on Consumer Finance (NCCF) 50 years ago—consumer protection, competition, information, inclusion, and regulatory modernization.

This chapter turns to three loosely related issues that relate to the general theme of consumer empowerment.

First, it examines financial education and literacy. Financial education is widely recognized as an important tool of consumer empowerment that can help consumers make sound financial decisions, build wealth, and maintain economic security and well-being. Today, the potential value of financial education is greater than ever, as the rapidly growing complexity of the modern economy and financial services as well as the accelerating pace of change of financial services has put increasing demands on consumers to keep up with changing opportunities. This rapid pace of change has also raised new threats to consumers of potential harm.

State and federal governments, schools, non-profits, and for-profit firms invest substantial amounts of time and money to build financial literacy. Despite near-universal agreement on the potential value of financial education in empowering consumers and helping them to protect themselves from financial harm, traditional financial education efforts have shown modest improvement in financial skills and decision-making. However, recent studies have started to show some promise of improved techniques for improving financial literacy. Though, even at its most optimal, financial education is not a panacea and is not a substitute for enforcement, regulation, supervision, and information disclosures. Financially literate consumers can improve their own welfare and protect themselves from harm directly. Financially literate consumers also can provide a complement to the Bureau's other tools (such as enforcement and supervision) to make them more effective and to reduce their need in some instances. In addition, financially educated consumers can make better use of information provided through advertising and required disclosures in shopping while also exercising some ability to protect themselves from deception and other harms.

Second, we examine the situation of younger Americans today. Although the history of the past several decades as it applies to consumer finance has been largely one of continuous evolution in the same general direction, in many ways the issues for younger Americans today represent a discrete break in that smooth development in two ways. First, younger Americans today are entering adulthood with large amounts of student loan debt, the implications of which still remain poorly understood. In roughly thirty years, student loan debt has grown from a relatively small element of the consumer financial system to the second-largest tranche of debt on the average household balance sheet behind mortgages. Second, younger Americans are absorbing a dramatic technological transformation in how they use and interact with financial services and providers, undergoing rapid adoption of new technologies and new types of financial services providers.

Finally, we examine the financial circumstances of older Americans. Media stories are full of frightening reports on the supposedly dire circumstances of current and future retirees. The final section of this chapter examines the financial well-being of older Americans and the changes in retirement planning and behavior that should be kept in mind in assessing the financial condition of older Americans.

12.1 Financial Education and Literacy

The NCCF viewed financial education as closely allied with the subject of disclosure and its recommendations to make disclosure more effective.[1] The NCCF maintained that consumers who lack understanding of financial products may not be able to obtain the full benefits of a

[1] *See* discussion in Chapter 7.

competitive market. For a market to function properly, the consumers must possess information necessary to make intelligent decisions and know how to use the information to evaluate alternatives. Disclosure regulations may provide useful information, but they do not ensure that consumers understand or use the information provided in disclosures. Financial education aims to improve consumers' ability to assess benefits, costs, and risks of using credit. In addition to increasing the effectiveness of existing financial protections, the NCCF believed that financial education also would promote competition and reduce the need for further regulation by enabling consumers to more effectively protect themselves. Financial education has broad support, both financially as well as a matter of public opinion. However, earlier research raises questions about the effectiveness of financial education programs.[2] This research finds that participation in financial education programs is associated with generally small improvements in financial decisions. The literature provides some suggestions for improving the effectiveness of financial education but it also calls for further research on how financial education and disclosures can be made more effective. More recent research has challenged this traditionally skeptical conclusion and suggests a greater potential for education to improve financial choices and overall well-being.[3]

The Consumer Financial Protection Bureau (CFPB) estimates that government and private entities in the United States directly spend hundreds of millions of dollars every year to provide consumer financial education. The CFPB estimate does not include substantial indirect costs, such as the opportunity cost for the large investment in time spent by students and teachers in financial education classes instead of other subjects.[4] The need for greater levels of financial literacy has only increased as the complexity of the consumer credit products and the variety of options being offered to consumers has proliferated.

The Taskforce on Federal Consumer Financial Law enthusiastically endorses the potential value of consumer education as a crucial tool of financial empowerment and individual flourishing. Poor financial management skills can lead to psychological, emotional, and even physical distress. But the Taskforce also shares the frustration of some observers with the lack of quality assessments of the value of financial education interventions. The Taskforce calls on the CFPB

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[2] Daniel Fernandes, John G. Lynch, and Richard G. Netemeyer. A Meta-Analytic and Psychometric Investigation of the Effect of Financial Literacy on Downstream Financial Behaviors, 60 Management Science 1861, 1861-63 (2014).

[3] *See* Tim Kaiser, Annamaria Lusardi, Lukas Menkhoff, and Carly J. Urban, *Financial Education Affects Financial Knowledge and Downstream Behaviors,* NBER Working paper No. 27057 (Apr. 2020).

[4] The Consumer Financial Protection Bureau estimated that government and private entities in the United States incurred $670 million in direct expenses for providing financial education in 2013. US Consumer Financial Protection Bureau. Navigating the Market: A Comparison of Spending on Financial Education and Financial Marketing (2013), *available in* https://files.consumerfinance.gov/f/201311_cfpb_navigating-the-market-final.pdf (accessed October 27, 2020). Total expenses for financial education are greater. See discussion of the financial education environment below for details.

and others engaged in the task of consumer financial education to redouble their efforts to evaluate the marginal benefits and costs on investments in consumer financial education and to recommend improvements and more effective approaches where warranted.

This section is organized as follows: The next section discusses the financial education landscape today that describes the various sources and providers of financial education materials. The next section discusses different ways of promoting and measuring the effectiveness of financial education training through general studies of financial literacy and financial education intervention studies. The section that follows then discusses empirical evidence on the effectiveness of financial knowledge for improving consumers' financial decisions. The final section discusses the implications of empirical findings for improving the effectiveness of financial knowledge for improving outcomes and suggests additional research to guide financial education and disclosure policy.[5] The terms "financial literacy" and "financial education" are used interchangeably throughout this discussion, as is conventional in the field.

12.1.1 The Role of Financial Education in Consumer Empowerment

Financially literate consumers will make financial choices that improve their personal financial well-being. But they also provide a public benefit of promoting the efficient functioning of markets, searching for lower prices on products and services and rewarding high-quality providers of financial services. Educated consumers can also be a powerful ally in minimizing harm to themselves and other consumers by taking self-help measures to protect themselves from fraud and deception.

The goal of financial education is to provide consumers with the general knowledge and skills that will enable them to make better financial decisions. The tools include both particular facts and more general knowledge and skills that can be adapted to new decisions as they arise and which can be applied to acquire relevant facts and information in the future. Basic financial education, therefore, also complements laws and regulations that require certain mandated and standardized disclosures as well as voluntary information offered by providers through advertising and similar means. Financially educated consumers will make better use of this information to improve their personal financial decisions more efficiently but will also help promote a more efficient and transparent market that enables consumers to choose products that best satisfy their needs at the lowest prices. In facilitating more competitive markets,

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5 An Appendix to this chapter summarizes the recommendations of the National Commission on Consumer Finance (1972) for financial education policy. National Commission on Consumer Finance, Report of The National Commission on Consumer Finance, Consumer Credit in the United States 214 (Dec. 1972).

effective financial education benefits all consumers and the economy at large, not just those consumers whose decisions benefit directly from greater financial knowledge.[6] Moreover, more educated consumers can be powerful allies to regulatory agencies in rewarding high quality financial providers and weeding out low quality providers from the market.

As noted in Chapter 6, financial education and literacy is one of the tools or "functions" specifically granted to the CFPB in Dodd-Frank Act. This aspect of the Bureau's mission is reflected in numerous provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) that charge the Bureau with researching, developing, promoting, and implementing financial literacy programs and activities. Indeed, financial education is the first function listed among the Bureau's regulatory functions in the Dodd-Frank Act and is one of the four offices the Dodd-Frank Act requires the Bureau's Director to establish.[7] In addition to needing a safe, transparent marketplace, which the Bureau addresses through its supervision, enforcement, and rulemaking functions, consumers need the financial capability to navigate the marketplace effectively to advance their own life and financial goals.

The act tasked the CFPB with substantial responsibilities for financial education to develop and implement initiatives intended to educate and empower consumers to make better informed financial decisions and to improve the financial literacy of consumers through programs and activities. The Bureau's initiatives cover a wide range of topics and decisions that arise in consumers' financial lives. In its 2019 Financial Literacy Annual Report, the CFPB reported that it reached 12 million individuals through digital and print media.[8] The Bureau's financial education initiatives reached individuals in the general population as well as specific groups such as parents with young children, college students, older individuals, and military families. The Bureau delivered training and materials to support financial education providers. The Bureau also conducted research on effective financial education and financial well-being. Notable among the CFPB's initiatives is research (discussed later in this chapter) into how to define and measure the success of different financial literacy strategies.[9]

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[6] A similar process is suggested in theoretical work in the economics of information, which shows that all consumers need not search for a market to be competitive. Competitive outcomes are possible even when only a fraction of consumers are informed. *See* Alan Schwartz and Louis Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. Rev. 630 (1979).

[7] 12 U.S.C. §5493(d).

[8] Bureau of Consumer Financial Protection, Financial Literacy Annual Report (Dec. 2019).

[9] Consumer Financial Protection Bureau, Financial Well-Being: The Goal of Financial Education (Jan. 2015).

[10] Council for Economic Education. Survey of the States: Economic and Personal Finance Education in Our Nation's Schools (2020), *available at* www.councilforeconed.org/survey-of-the-states-2020/.

12.1.2 The Financial Education Landscape Today

A wide variety of entities provide financial education programs. They include educational institutions, non-profit organizations, consumerist organizations, financial firms, employers, state and local governments, and the federal government. Programs deliver education through classroom instruction, one-on-one counseling, technology interventions, and self-study among others.

Major Entities Providing Consumer Financial Education

State mandates for economics or personal finance education in schools are common. The specific requirements differ. Most states require a single comprehensive course. In 2020, 24 states required schools to offer a course in economics and 23 required students take a course in economics.[10] Twenty-four states required schools to offer a course on personal finance and six states required that students take a course in personal finance. Fifteen states allowed schools to satisfy a financial education mandate through personal finance instruction in a related course that dedicated a portion of the curriculum to personal finance.[11] Only five states and the District of Columbia did not include personal finance or economics in their school standards.

Homeownership counseling has long been required by the US Department of Housing and Urban Development in conjunction with a variety of affordable housing programs.[12] Requirements for homeownership counseling have largely focused on lower income consumers and first-time homebuyers. The counseling aims to prepare these consumers to take on the responsibilities of homeownership. Turmoil leading to the financial crisis in 2008-2009 stimulated the growth in counseling to address mortgage delinquency and to provide guidance for refinancing. As mortgage credit standards became tighter and fewer lower income consumers qualified for mortgages, pre-purchase counseling declined.[13]

Fostered by its trade association, the National Foundation for Credit Counseling (NFCC), the traditional, non-profit credit counseling industry emerged in the second half of the 20th

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[10] Council for Economic Education. Survey of the States: Economic and Personal Finance Education in Our Nation's Schools (2020), *available at* www.councilforeconed.org/survey-of-the-states-2020/.

[11] Personal finance might be integrated in of curricula such as home economics, economics, business, mathematics, or social science. The National Commission on Consumer Finance recommended this approach to financial education in schools (see the appendix to this chapter). The commission argued that this approach would seem more relevant to students than a single course that is of little immediate use. *See* NCCF Report, *supra* note 5.

[12] Herbert, Christopher E., Jennifer Turnham, and Christopher N Rodgers, *The State of the Housing Counseling Industry: 2008 Report,* US Department of Housing and Urban Development, Office of Policy Development and Research (September 2008).

[13] *Id.* Interest in reverse mortgages by older consumers has also stimulated growth in homeownership counseling.

century.[14] NFCC-member credit counseling agencies provided consumers several services—consumer financial education, budget counseling, negotiating debt relief, and, when appropriate referring, consumers to other support organizations.

The debt relief service, called the Debt Management Plan (DMP), finances the traditional NFCC-member non-profit counseling agencies and provides some relief to distressed borrowers. For the debt management plan, a counselor reviews a borrower's budget and provides financial advice. If the borrower is deemed to have ability to permit repayment of a significant amount of the borrower's unsecured debt, the counselor seeks to set up a voluntary agreement between the borrower and the borrower's creditors to lower monthly payments. In some cases, the agreement may include concessions on finance charges and repayment terms. Lender "fair share" payments provide most of the financing for NCCF-member agencies. The fair share amounts to about 12 percent of debt payments that the counseling agency helped to facilitate.

NFCC-member counselling agencies also have provided credit counseling without a DMP, financial guidance for first time homeowners, reverse mortgage counseling, instruction for understanding credit reports and credit scores, guidance for repaying student debt, foreclosure prevention counseling, and bankruptcy counseling. In addition, the foundation certifies agency counselors for a variety of educational and remedial services.

The credit counseling industry grew rapidly in the early 1990s, from about 200 companies in 1990 to 1,200 companies in 1994.[15] Increased demand for counseling and use of technology to reduce the cost of delivering counseling fueled this growth. The new counseling agencies focused on DMPs, however, provided less or no financial education. They also relied more heavily on consumer fees than traditional NCCF-member agencies. The new counseling agencies put downward pressure on fair share rates and took market share from traditional agencies.

The new counseling agencies stimulated changes in the industry. Traditional agencies turned to communications and information technology to reduce their costs for delivering counseling services. Creditors made greater efforts to screen the counseling agencies for effectiveness. High consumer fees, lack of transparency, and low DMP completion rates for some new agencies also attracted legislative and regulatory scrutiny.

An amendment to federal bankruptcy law that became effective in October 2005 requires that all consumers receive credit counseling from a court-approved nonprofit agency before filing for bankruptcy and another round of counseling before receiving a discharge of their debts under

[14] Robert M. Hunt, *Whither Consumer Credit Counseling?*, Federal Reserve Bank of Philadelphia Business Rev. 9 (Fourth Quarter 2005).

[15] *Id.* at 15

either Chapter 7 or Chapter 13 of the Bankruptcy Code. Each of these counseling requirements seems to envision either a rehabilitative or preventive role for credit counseling to avoid future financial problems.

The Financial Literacy and Education Commission (FLEC) was created by statute in 2003 "to serve to improve the financial literacy and education of persons in the United States through development of a national strategy to promote financial literacy and education."[16] The FLEC comprises 23 federal government entities, reflecting a wide array of government functions and is chaired by the Secretary of the Treasury with the Director of the CFPB serving as Vice-Chair. The FLEC was charged with developing a national strategy to promote basic financial literacy and education among all American consumers, and annually reviewing and making such changes and recommendations as it deems necessary.[17]

The FLEC serves to improve the role of the federal government by streamlining, improving, or augmenting the financial literacy and education programs, grants, and materials of the federal government, including curricula for all Americans.[18] With this goal, it works to equip consumers with the skills, knowledge, and tools to make decisions that enhance their financial well-being. Approaches include policy development, research coordination, and focused program and resource development. The 2020 FLEC National Strategy reflects the belief that the federal government can help facilitate a vibrant and efficient marketplace that empowers individuals to make informed financial choices.

Direct Expenditures for Financial Education

Investments in financial education in the United States are substantial. According to a 2013 CFPB estimate, annual *direct* spending on training in financial literacy all together amounted to approximately $670 million per year, of which about two-thirds of that total ($472 million) was through various non-profit entities and $125 million (46 percent of federal spending) is directed towards military and veterans.[19] This direct cost estimate excludes the implicit cost of financial literacy education in terms of the opportunity cost to those, such as school teachers and students, who spend time on financial education instead of other school subjects.

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[16] 20 U.S.C. § 9702(b). *See also* US Financial Literacy and Education Commission, *U.S. National Strategy for Financial Literacy* (July 31, 2020), *available at* https://home.treasury.gov/policy-issues/consumer-policy/financial-literacy-and-education-commission.

[17] 20 U.S.C. § 9703(f).

[18] 20 U.S.C. § 9703(a)(1).

[19] Direct costs alone exceeded the entire budget of the CFPB in 2013 ($479 million). *See* Consumer Financial Protection Bureau, FY 2013 Budget Justification (2013).

12.1.3 Research on Consumers' Financial Literacy

Research on financial literacy and education often starts with a formal economic life-cycle model of consumption over time.[20] The details of the research differ, but the basic structure of the various models is similar: Individuals receive an income stream and seek to achieve highest valued possible time pattern or consumption over their lifetime. They may borrow when young, when income is relatively low and returns on household investment in durables are high, pay down debts and save during high earning years, and rely on social security and savings to support consumption in retirement. Decisions may be influenced by a variety of factors including borrowing constraints, mortality risk, demographic factors, stock market returns, tax considerations, and earnings and health shocks. In some models, individuals may incur costs for acquiring financial knowledge to improve the financial outcomes, which allow them to obtain a higher-valued distribution of intertemporal consumption. An important implication of allowing individuals to choose the amount of financial information and knowledge to acquire is that they will choose different types and amounts depending on their circumstances. For example, Lusardi and Mitchell hypothesize that individuals with limited education might rationally choose not to incur the costs of increasing financial knowledge because, having few assets or discretionary income to invest and anticipating receipt of social security income in old age, they would obtain little benefit from such knowledge.

Lusardi and Mitchell argued that knowledge of several concepts is fundamental to making saving and investment decisions in a life-cycle framework.[21] Key concepts include effects of interest compounding, inflation, and risk diversification. They developed three test questions for these concepts to measure individuals' basic understanding in these areas, and contended that correct answers indicated financial literacy. They also developed an expanded set of test questions on financial knowledge specifically for savings and investment decisions and knowledge relevant for borrowing decisions.[22]

Lusardi and Mitchell's three test questions were included in the 2004 Health and Retirement Study, which surveyed a representative sample of individuals in the US aged fifty years or older. Large percentages of respondents provided incorrect answers to the questions about the three concepts or said that they did not know the correct answer. (Incorrect or "do not know" answers

[20] See Tullio Jappelli and Mario Padula, *Investment in Financial Literacy and Saving Decisions*, 37 J. of Banking and Fin. 2779-92 (2013); *see also* Annamaria Lusardi and Olivia S Mitchell, The Economic Importance of Financial Literacy: Theory and Evidence, 52 J. Econ. Lit. 5-44 (2014).

[21] Lusardi and Mitchell, *Economic Importance*, *supra* note 20.

[22] See Annamaria Lusuardi and Olivia S Mitchell, How Ordinary Consumers Make Complex Economic Decisions: Financial Literacy and Retirement Readiness. CFS Working Paper No. 2010/11 (2010); see also Annamaria Lusardi and Peter Tufano, Debt Literacy, Financial Experiences, and Overindebtedness (CFS Working Paper No. 2009/08, 2009).

were accounted for 33, 25, and 48 percent for the test questions on interest compounding, inflation, and risk diversification, respectively).[23] Responses to these questions by other population groups produced similar large percentages of individuals who were unable to provide correct answers.[24] The inability of large percentages of individuals that did not correctly answer questions about financial concepts led Lusardi and Mitchell to conclude that the level of financial literacy is quite low.

CFPB Research on Financial Knowledge and Ability

As of its research responsibilities, the CFPB reviewed much of the literature on financial education and literacy, including but not limited to the work of Lusardi and Mitchell.[25] The Bureau's review noted considerable heterogeneity among studies. Results seem inconsistent, with different studies appearing to point in different directions, but several general conclusions emerged. Financial literacy (measured as correct answers to Lusardi and Mitchell's test questions on financial concepts) is correlated with behavior generally viewed as good financial practice. However, when personal traits and actions including confidence, ability to search, propensity to plan, and willingness to take prudent investment risks are examined, the effects of measures of financial literacy are smaller.

Further, the review found that participation in financial education programs does not necessarily lead to improved financial knowledge. It even appears that education based on general behavioral concepts or "rules of thumb" (heuristics) may be more effective than that based on financial concepts, although research on causal relationships between financial knowledge and behavior is quite limited. Few studies have combined large samples, long time spans, and control populations. In many cases, the relevant concepts have been loosely defined. The Bureau also found a lack of generally-accepted definitions and measurements of financial knowledge, behavior, and well-being.

The report discussed Bureau research aimed at providing standards for future research, leading to proposing improvement in individual financial well-being as the goal of financial education. Financial well-being involves having control over day-to-day finances, capacity to withstand financial shocks, meeting financial goals, and freedom to make choices that contribute to

[23] Sixty-six percent gave incorrect answers or said that they did not know the correct answer for two or more questions. Ten percent gave incorrect answers or said that they did not know the correct answer for all three questions.

[24] Lusardi and Mitchell, *How Ordinary, supra* note 22; *see also* Annamaria Lusardi, Olivia Mitchell, and Vilsa Curto, *Financial Literacy and Financial Sophistication in the Older Population,* 13 J. Pension Econ. and Fin. 347 (2014).

[25] CFPB, Financial Well-Being, *supra* note 9.

enjoyment of life. The Bureau sought to identify specific types of knowledge, behavior, and personal traits that are associated with financial well-being.

The Bureau hypothesized that the financial knowledge that supports financial well-being consists of a set of skills. The set of skills identified as necessary to make effective decisions involve knowing when and how to find reliable information, how to process the information, and how to implement the decision. Knowing facts alone is not enough. Consumers need these skills to achieve financial well-being. The Bureau also hypothesized that certain personal traits facilitate achievement of financial well-being. They include an ability to develop one's own standards, persevere, plan for the future, control impulses, and be confident in one's ability to influence financial outcomes. Traits have been recognized to be associated with financial behavior and outcomes but may not be susceptible to financial education.[26] Personal characteristics may impose non-trivial constraints on our ability to move the needle of financial education, and that we should take that into account in thinking about how we deliver financial literacy interventions and weighing the marginal benefits and costs of financial literacy investments.

In summary, as a country the US spends substantial amounts of money and time for financial education but historically has had little to show for it. Recent research, however, has started to show more promise than earlier studies, although it is clear that although financial education is an important component of consumer financial protection and financial well-being, it is not a substitute for a robust program of enforcement, supervision, and regulation, where appropriate. Studies suggest that basic financial literacy skills are relatively low and knowledge deteriorates rapidly without repeated use.

Further, the CFPB's literature review revealed critical gaps in existing research from the perspective of the CFPB's specific need for broadly applicable, evidence-based measures through which to identify effective financial education approaches. Its report underscored the need for widely agreed-upon definitions and measures of financial well-being and its key drivers as a necessary first step toward research into effective education strategies. The Task Force endorses the Bureau's efforts to develop criteria for measuring the effectiveness of interventions in raising financial well-being going forward.

[26] Many financial behaviors such as saving and credit scores are correlated with other personal behaviors such as the propensity to smoke, exercise, and eating behaviour. *See* Richard A. Ippolito, *Education Versus Savings as Explanations for Better Health: Evidence from the Health and Retirement Survey* (George Mason Univ. School of Law, Law and Economics Working Paper Series 03-04, 2002); Scott Adams, Niloy Bose, and Aldo Rustichini, *How Different are Smokers? An analysis Based on Personal Finances*, 107 J. Econ. Behav. & Org. 40 (2014).

Evaluating Efforts at Financial Literacy and Financial Education Intervention: What Works?

Because of the importance of outcomes in the area of financial literacy, it's worthwhile to review the research and its implications. The substantial dedication of resources to financial literacy training and financial education programs considerably stimulated studies seeking to assess the effectiveness these efforts on consumers' financial behavior. Basically, researchers have measured consumer financial knowledge in one of two ways: (1) measuring general financial literacy such as understanding *basic knowledge of financial concepts* like compound interest, inflation, or risk diversification (the Lusardi-Mitchell approach) or (2) measuring specific *knowledge acquired through financial education initiatives*, participation in financial education programs such as financial education classes or credit counseling. Effects measured include differences in financial decisions and behavior associated with the measures of financial literacy or participation in a financial education initiatives.

Studies sometimes called "intervention studies" look at the impact of participation in various financial education programs. Financial education intervention studies are generally experimental or quasi-experimental assessments of the effects of financial education on subsequent financial outcomes. Again, the intent is to look for outcomes consisting of behavior that is generally considered good financial practice.[27] Simply knowing facts, such as knowing correct answers to test questions, does not ensure that an individual is capable of making sound financial decisions. Individuals must be able to use their knowledge effectively. Thus, much of financial literacy efforts have focused on not merely improving levels of abstract knowledge of financial concepts but effecting tangible changes and improvements in behavior and real-life decision-making. Many papers have examined whether financially literate individuals achieve better financial outcomes than financially illiterate individuals. Several studies have used meta-analysis to survey this vast literature.[28]

Meta-analysis is a statistical technique of combining data from other studies to estimate the effect of a common variable—such as in this case measured financial literacy or participation in a financial education program—on an outcome, in this case behavior that is good financial practice. In a meta-analysis of this kind, Fernandes, Lynch, and Netemeyer reviewed the

[27] Good financial practices are easier to identify in some cases than in others. An increase in savings would generally be considered good financial practice in most cases. An increase in debt is not as clearly good practice because the debt may be used to finance the acquisition of productive household assets like housing or durable goods but not always.

[28] *See* Tim Kaiser and Lukas Menkhoff, *Does Financial Education Impact Financial Literacy and Financial Behavior, and If So, When?* 31 The World Bank Econ. Rev. 611 (2017); *see also* Margaret M. Miller, Julia Reichelstein, Christian Salas, and Bilal Zia, *Can You Help Someone Become Financially Capable? A Meta-Analysis of the Literature,* 30 World Bank Research Observer 220 (Aug. 2015); Fernandes, et al., *supra* note 2; Tim Kaiser and Lukas Menkhoff, *Financial Education in Schools: A Meta-Analysis of Experimental Studies,* 78 Econ. of Ed. Rev. 1 (2020).

findings of 168 such papers containing 201 non-redundant studies, which were systematically selected to produce a representative sample.[29] They also conducted original analyses.

Fernandes, Lynch, and Netemeyer examined the two types of studies already introduced here assessing the effects of financial knowledge on outcomes of financial decisions. First, they assessed outcomes of the financial literacy of individuals defined by the percentage of correct answers on test questions on financial knowledge, such as the test questions of Lusardi and Mitchell. These studies Fernandes, Lynch, and Netemeyer called *measured financial literacy* studies. The other type were the studies that compared outcomes of individuals who participated in various financial education programs were called *financial education intervention* studies. As indicated earlier, financial education intervention studies are experimental or quasi-experimental assessments of the effects of financial education on subsequent financial decisions.

Their review indicated that financial education intervention studies have statistically significant but inconsiderable effects on behavior. Measured financial literacy studies have larger significant effects than financial education intervention studies, but the effects of measured financial literacy are still very small. Results varied by the studies' research design, with stronger designs estimating smaller effects than weaker designs.[30]

Studies of measured financial literacy have used instrumental variables in efforts to account for possible bias from omitted variables, which may occur if an omitted variable is correlated with both financial literacy and financial behavior. For example, personal characteristics (such as confidence in information search, propensity to plan, willingness to take financial risks, and numeracy) might be correlated with financial literacy but also with positive financial behavior (such as saving for emergencies, planning for retirement, and avoiding overdraft or late fees). In their original analyses, Fernandes, Lynch, and Netemeyer found that measured financial literacy was significantly related to positive financial behavior after accounting for individuals' demographic characteristics. However, when they added personal characteristics to the model, measured financial literacy was statistically insignificant. These personal characteristics quite

[29] Fernandes, et al., *supra* note 2. If two papers analyzed the same data, they included the paper with the most inclusive sample. Pre-test/post-test studies were included only if the post-test was at least two weeks later than the pre-test. They excluded studies that did not provide sufficient information to calculate effect size.

[30] For instance, experimental studies of financial education interventions produced smaller effects than quasi-experimental studies, and studies of measured financial literacy using instrumental variables produced smaller effects than studies using ordinary least squares. These finding stand in sharp contrast to Lusardi and Mitchell, *Economic Importance*, *supra* note 20, who pointed to selected studies that report larger effects for instrumental variable regressions than OLS regressions. As mentioned, Fernandes, Lynch, and Netemeyer, *supra* note 2, results are based on a systematically selected set of a large number of studies and likely is more representative of such studies than Lusardi and Mitchell's paper. Also, Fernandes, Lynch, and Netemeyer report standardized effects (partial correlation coefficients) to facilitate comparisons of effects across models.

plausibly are related to the acquisition of financial knowledge and positive financial behavior, a conclusion that is consistent with these findings.

Fernandes, Lynch, and Netemeyer found that effects of financial literacy manipulated by intervention decay at a decreasing rate with the passage of time. The decay over time is greater for larger interventions (measured by hours of instruction) than for smaller interventions. However, after twenty-four months, the effect of the intervention is about the same regardless of the size of the intervention.

Meta-analyses by other researchers have found generally positive but small effects of financial education interventions on financial outcomes similar to those of Fernandes, Lynch, and Netemeyer. Miller et al. analyzed data from 188 studies to estimate effects of financial education interventions on four outcomes—increasing overall saving, contributing to retirement savings, defaulting on a loan, and keeping financial records.[31] On balance, they found small, sometimes statistically significant positive effects on overall saving, retirement saving, and record keeping behavior but no effect on loan defaults. Miller et al.'s findings suggest that interventions are likely to be more effective influencing some types of outcomes than others. Due to limitations of the data, Miller et al. were unable to draw conclusions on what characteristics of interventions (delivery channel, location of the intervention, and hours of instruction, for example) contributed to better outcomes.

In another meta-analysis, Kaiser and Menkoff examined 126 education interventions reporting 539 effect sizes. Outcomes considered concerned saving, borrowing, budgeting, insurance, remittances, and bank account ownership. They found somewhat small to moderate, statistically significant positive effects for saving and budgeting. Effects for borrowing, insurance, remittances, and bank account ownership were small and not statistically significant.[32] Kaiser and Menkoff's analyses indicated that the effects of interventions increase with the hours of instruction increase and are greater when they are offered at a teachable moment (that is, when motivation to learn is high because a decision is imminent). They found that effects of financial education interventions were smaller for low-income consumers than the effects for middle and higher income consumers. Low-income consumers were responsive to teachable moments, but less so than middle and higher income consumers.

Kaiser and Menkoff examined the 37 studies of the effects of financial education on school students. They found positive, statistically significant effects of financial education on financial literacy, measured by responses to test questions. These effects were comparable to effects of

[31] Some of the interventions in Miller et al.'s study were interventions outside the US. *See* Miller et al., *supra* note 28.

[32] Kaiser and Menkhoff, *supra* note 28. This study included some interventions outside the US.

instruction for other school subjects. The effects of education on financial behavior, measured by an increase in savings or observed choices in an experimental task, were much smaller than the effects on financial literacy. It is notable that school students do not have the opportunity to make many financial decisions, though. Little or no immediate use of the financial knowledge may inhibit retention, and retained knowledge likely decays before students are ready to make significant, real financial decisions.

More recent analysis, however, has identified more encouraging results and suggests that well-designed financial education studies may be more successful at improving financial knowledge and financial behaviors than earlier studies had found. Kaiser, et al., surveyed 76 randomized experiments involving more than 160,000 individuals to assess the effects of financial education interventions.[33] Evaluating the results of those interventions, the authors concluded that the effect of financial education interventions was approximately three to five times larger than prior studies had found.[34] Moreover, they found that the results have economic significance. In contrast to earlier studies they also did not find differences in treatment effects for low-income individuals relative to the general population and they also did not find strong evidence of either rapid decay of knowledge (although they also found no evidence of long-term sustainability of knowledge). Their finding of more significant effects from financial education interventions may result in part from the larger number of studies that have become available over time that have increased the statistical power of recent studies relative to earlier, smaller meta-studies and thereby identified marginal effects that were statistically insignificant in earlier studies.[35] The authors also conduct "back of the envelope" analysis of the cost effectiveness of consumer financial education but note that there is a need for further analysis of the costs of financial education programs in assessing their overall usefulness. The results of this meta-analysis suggests that financial education may have more promise to improve financial knowledge and behavior than previously though.

In summary, reviewing these studies and meta-studies suggests several conclusions about the effectiveness of current financial literacy programs:

1. The expenditure of public and private resources in financial literacy programs is substantial, amounting to $670 million in direct expenses alone in 2013. This does not include the opportunity cost of time spent by teachers, students, and others studying financial education in school or elsewhere. More research on the total costs of financial

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33 Kaiser, et al., *Financial Education, supra* note 3.

34 *Id.* at 3.

35 *Id.* at 16.

education and effectiveness of different channels of delivery relative to their costs would be valuable.

2. The effects of financial education were found to be positive but typically small. Recent studies, however, suggest greater potential for financial education to meaningfully improve financial decision-making.

3. Financial literacy education, once acquired, may decay rapidly, just like other education unless it is reinforced through repeat usage.

4. Financial education aimed at improving decision-making at the time of a "teachable moment" (just in time education) is effective, but the knowledge also tends to decay without usage and over time.

5. The particular financial decisions consumers have to make evolve over their life-cycle, for example, younger consumers may need to focus on budgeting and how to use credit, middle age on investing, and older retirees on allocating their resources over the rest of their lifetime.

6. Not all elements of skills related to financial decision-making can be changed with equal effort. For example, learning basic budgeting and savings skills may be easier than deciding on the type of mortgage to finance acquisition of a house or other complex credit usage decisions. Behaviors that can become routine or habitual may be more likely to be successful than those that require ongoing cognitive attention.

7. Financial literacy knowledge and demonstrated decision-making are highly correlated with many other underlying personal characteristics that might be difficult to change. This suggests that there may be external constraints on the realistic effectiveness of financial education.

Financial education is an important societal and governmental function and the potential returns may be large. Yet to date, there has been few efforts to assess the extent to which the return on those investments generate a positive return to the public or to determine whether the marginal benefits of particular investments exceed the marginal costs in terms of financial resources and the opportunity cost of time spent. There should be a better effort to determine more rigorously the marginal return to different investments at different times, such as the value of general financial literacy and the appropriate stage of a consumer's lifecycle as opposed to discrete just-in-time or "teachable moment" interventions. There also should be care about adopting one-size-fits-all approaches in light of the correlation with personal characteristics.

12.1.4 Implications of Findings for Improving Financial Knowledge and Decisions

Fernandes, Lynch, and Netemeyer offered several possible explanations for the weak effects of financial education that they found. They noted that financial education competes for consumers' attention with other information available in the market. Without a ready expected use, consumers' motivation to acquire knowledge may be weak. This argument favors just-in-time financial education tied to a particular decision over youth financial education interventions intended to affect behavior in the distant future.

Their finding that knowledge decays over time suggests that imminent use of acquired information aids retention. Time-sensitive content knowledge is likely to be forgotten. Over time, consumers are likely to forget information that is not used.

The content of a given financial education intervention may be useful in some situations but not in other situations. For example, teaching budgeting skills might be useful to consumers with limited resources. In contrast, consumers with significant surpluses in their budgets may not need to budget their expenses as carefully and therefore may obtain less benefit from such education.[36] Uncertainty also may affect the usefulness of financial education interventions. Stating normative behavior is difficult when neither instructors nor consumers can anticipate future circumstances.

Multiple-skill, multiple-behavior programs may be less effective than single-behavior programs. Consumers may perceive less relevance and give less attention to broad-based programs that address some future, as yet unanticipated, decisions than single-behavior programs addressing a specific known and imminent decision. Some studies suggest that interventions promoting traits such as propensity to plan, confidence to be proactive, and willingness to take financial risks may be more effective for achieving utility increasing outcomes than content knowledge about financial mathematics or financial markets, and instruments.[37]

Financial education interventions appear to be more effective for some types of behavior (saving and budgeting) than others (credit use and payment behavior).[38] Saving and budgeting may become routine and thus require minimal ongoing cognitive effort or conscious attention. In

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[36] Jing Jian Xiao and Barbara O'Neill, Mental Accounting and Behavioural Hierarchy: Understanding Consumer Budgeting Behaviour, 42 Intl. J. Consumer Studies 448 (2018).

[37] Liat Hadar, Sanjay Sood, and Craig R. Fox, *Subjective Knowledge in Consumer Financial Decisions,* 50 J. Marketing Res. 303 (2013).

[38] Kaiser, et al., *supra* note 3, at 18. There were an insufficient number of studies of certain behaviors, such as usage of insurance and remittances, to draw firm conclusions about the impact of financial education interventions.

many cases, repayment of debts also may become routine. Credit use and payment behavior seems more complicated. Greater use of debt may arise from greater household investment, but sometimes greater debt may be due to from greater risk tolerance or even improvidence. Debt repayment problems often are the result of unexpected adverse effects. Financial knowledge may not prevent payment problems, and financial education interventions (typically, credit counseling) may not help much when problems arise.

Financial knowledge needs are not homogeneous. Evidence indicating that education interventions have smaller effects for lower income consumers than middle and higher income consumers suggests that programs designed for middle and higher income may not serve lower income consumers very well. The NCCF recognized many years ago a need for education programs designed for lower income consumers. The recent evidence suggests that this NCCF recommendation has not been effectively implemented.

Further study of decision processes and outcomes is also needed to resolve differences in implications of behavioral analyses for financial literacy and education. For instance, the "heuristics and biases literature" beginning with Tversky and Kahneman and that has become well known in other contexts does not find much of a role for financial education to improve financial decisions.[39] According to this literature, consumers often use heuristics (rules of thumb) to simplify decisions but are error-prone.[40] Errors are systemic and hardwired in the brain. Consumers often do not realize their mistakes. Education (and also disclosure) can have little effect on behavior under this circumstance. In contrast, the "fast and frugal heuristics literature" views heuristics as experience-based decision-making shortcuts for specific environments.[41] Actual choice environments are characterized by asymmetric, incomplete, and even false information. Heuristics enable consumers to make decisions quickly using limited information, especially when the future is uncertain. Evidence indicates that such heuristics perform well, sometimes better than methods involving extensive information and evaluation of tradeoffs among alternatives.[42] Financial education interventions informed by understanding

[39] *See* Amos Tversky and Daniel Kahneman, *Judgement Under Uncertainty: Heuristics and Biases*, 185 Science 1124 (1974); *see also* Amos Tversky and Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 Science 453 (1981).

[40] In the heuristics and bias literature, errors are decisions that violate rules of statistics, logic, of mathematics. An example is concluding that the probability that an individual is a bank teller *and* feminist is greater than the probability that an individual is a bank teller. The probability of any one of two events is always greater than the probability of the two events occurring together. See the discussion of the "Linda Problem" in Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd Zywicki, Consumer Credit and the American Economy 143-44 (2014).

[41] Gerd Gigerenzer, Peter M. Todd, and the ABC Research Group, Simple Heuristics that Make Us Smart (1999).

[42] Gerd Gigenzer and Henry Brighton, *Homo Heuristicus: Why Biased Minds Make Better Inferences*, 1 Topics in Cognitive Sciencw 107 (2009).

decision processes can improve outcomes by facilitating information acquisition and improving choice environments.

Public policy implications of the heuristics and biases program differ from those of the fast and frugal heuristics program. Heuristics and biases suggest that experts know desirable financial outcomes better than consumers. Regulation of products and nudges into decisions that are deemed in the best interest of consumers are the preferred policies. Fast and frugal heuristics generally respects differences in individuals' circumstances and preferences. The fast and frugal approach favors disclosure and financial education interventions that improve decision-making environments and facilitate achievement of better financial outcomes.[43]

Improving the consistency of measurement, assessment, and accountability in financial education programs is needed. The diversity of program goals, providers, and participants poses makes measuring and assessing the effects of financial education difficult. For financial education to be more effective, it must move toward more rigor in assessment and respond better to findings about what works and what does not.

12.2 Financial Issues Affecting Younger Consumers

Younger consumers today present a distinct profile from younger consumers of earlier eras as well as from older consumers. Younger Americans today face distinctive financial challenges as a result of two major economic shocks more than a decade, large student loan burdens, and regulatory and economic obstacles that have tended to delay their financial evolution into traditional financial products such as credit cards, mortgages, and bank accounts. At the same time, younger consumers have adopted new consumption and financial habits that have challenged traditional conceptions of how financial products are provided and used. They are more tech-savvy and responsive to the adoption of new technologies, such as FinTech and peer-to-peer payments. They are far less likely to use cash and checks as opposed to electronic payments and less attached to the traditional banking system. At the same time they embrace new financial technologies they also evidence a heightened awareness of the privacy and data security issues raised by new technologies. Overall, the changing financial habits of younger Americans reflect a variety of forces: changes in the financial challenges they face, changes in their usage and preferences for financial services, and changes in consumption habits that have

[43] Morris Altman, Implications of Behavioural Economics for Financial Literacy and Public Policy, 41 J. of Socio-Economics 677 (2012).

changed the mix of financial products they desire. As they form families, however, it appears that they are settling into more traditional financial patterns, including relocating to the suburbs and buying houses, cars, and consumer durables. It is likely that these general trends, especially trends impacted by FinTech and electronic payments, will have a long-term impact, reshaping the financial services marketplace permanently.

This section of the chapter will focus on some of the financial prospects and challenges facing the younger generations. It is divided into four parts. The first looks at aspects of overall financial condition of young consumers followed by a second discussion of a specific area of interest and concern for younger consumers, student loan debt. A third part briefly discusses how changing preferences for financial services and the use of technological solutions among younger consumers may have long-run implications for financial-services providers and markets. Part four examines the effects of certain regulations on younger consumers, particularly provisions of federal law that have reduced access to credit cards by those under the age of 21.

12.2.1 Overall Financial Well-Being Of Younger Consumers

The personal finances of the millennial generation have been shaped by several unusual economic and social developments Millennials, those born between 1981-1996,[44] were especially hard-hit by two major economic shocks: first, the 2008 financial crisis and subsequent Great Recession just as they were entering the workforce and second, the 2020 Covid-19 pandemic just a few years after the economy recovered from the earlier shock.[45] Millennials are the largest generation in American history and more racially diverse, educated, and likely to have deferred marriage than prior generations; although, these characteristics are largely a continuation of prior trends. Millennial households also have lower earnings, fewer assets, and less wealth than earlier generations, but comparable debt to Generation X.

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[44] Although generational line-drawing is always somewhat arbitrary and blurry around the margins, dividing populations into generational cohorts is a generally-accepted practice as an analytically useful tool to help get general pictures of trends in society. We focus here particularly on the two youngest adult generations in the American population today, generally referred to as the "Millennial generation" and "Generation Z." For current purposes we define the Millennial generation as including those born between 1981 and 1996 (the first cohort typically graduated from high school around the year 2000 giving rise to the name). *See* Michael Dimock, *Defining Generations: Where Millennials End and Generation Z Begins*, Pew Research Center (Jan. 17, 2019).

[45] *See* Christopher Kurz, Geng Li, and Daniel J. Vine, *Are Millennials Different?*, Federal Reserve Board, Divisions of Research & Statistics and Monetary Affairs, Finance and Economics Discussion Series, No. 2018-080 (Nov. 2018); Claire Williams, *Millennials and the Economy: Coronavirus Is the Second Setback in a Generation*, Morning Consult (Sept. 28, 2020), *available in* https://morningconsult.com/2020/09/28/millennials-economy-coronavirus-financial-impact-poll/.

Compared to earlier generations, Millennials are marrying later or not at all. According analysis by Pew Research Trust, only 44 percent of Millennials were married in 2019, compared with 53 percent of Gen X'ers and 61 percent of Boomers at a comparable age; and, those who married did so at a more advanced age.[46] The education gap in marriage—the higher rate of marriage by college graduates than others—is wider for Millennials than for prior generations. Unsurprisingly, Millennials are also having children at a later age than prior generations.

This tendency among Millennials toward later family formation has delayed many of their milestones toward financial maturity, including homeownership. However, contrary to conventional belief, millennials do not appear to exhibit radically different consumption preferences from earlier generations. Even before the onset of the Covid pandemic, as millennials aged and started families, they were following the well-hewn path of earlier generations by moving to the suburbs in pursuit of quality schools, affordable housing, and family-friendly amenities and lifestyles.[47] The Covid pandemic has accelerated this migration by millennials out of large cities.[48] If these trends continue, they should bring with them many of the traditional patterns of usage of household financial products including not just mortgages, but automobile loans and financing of consumer durables, just reaching these milestones at later ages than prior generations.

Generation Z, those born between 1997 and 2012, is just maturing into early adulthood and it is too early to assess their long-term prospects.[49] However, early signs indicate that members of Gen Z are highly tech-savvy, relatively averse to consumer debt (or, perhaps, less able to gain access to credit), and carry heavy student debt loads. They are still more racially and ethnically

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[46] See Amanda Barroso, Kim Parker, and Jesse Bennett, As Millennials Near 40, They're Approaching Family Life Differently Than Previous Generation, Pew Research Center (May, 27, 2020).

[47] *See* Janet Adamy and Paul Overberg, *Millennials Continue to Leave Big Cities,* Wall St. J. (Sept. 26, 2019), *available in* https://www.wsj.com/articles/millennials-continue-to-leave-big-cities-11569470460; Valerie Bauerlein, *American Suburbs Swell Again as a New Generation Escapes the City,* Wall St. J. (July 1, 2019), *available in* https://www.wsj.com/articles/american-suburbs-swell-again-as-a-new-generation-escapes-the-city-11561992889.

[48] *See* Diana Olick, *The Flight to the Suburbs is Real and Growing, as Coronavirus Changes the Way People Live,* CNBC.com (Jun 18, 2020), *available in* https://www.cnbc.com/2020/06/18/coronavirus-update-people-flee-cities-to-live-in-suburbs.html; Ian Bogost, *Revenge of the Suburbs,* The Atlantic (June 19, 2020), *available in* https://www.theatlantic.com/technology/archive/2020/06/pandemic-suburbs-are-best/613300/.

[49] Generation Z begins in 1997 and are expected to include those born until 2012. Generation X is conventionally defined as those born between 1965-1980 and Baby Boomers from 1946-1964. *See* Dimock, *supra* note 44. Generation Z is sometimes referred to as "iGen" because of the central role played by smartphones in their lives and personal development. *See* Jean M. Twenge, iGen: Why Today's Super-Connected Kids Are Growing Up Less Rebellious, More Tolerant, and Less Happy—and Completely Unprepared for Adulthood—and What that Means for the Rest of Us (2017).

diverse than Millennials.[50] They are on track to become the most-educated generation in history, being less likely to drop out of high school and more likely to enroll in college. In 2018, 57 percent of post-high school Gen Zers were enrolled in a two-year or four-year college. They are also more likely to have a college-educated parent than previous generations.

Older members of Gen Z were hit even harder by the Covid pandemic and governmental responses to it than Millennials. According to a Pew Research Center survey, half of the oldest Gen Z'ers (18 to 23) reported they or someone in their household had lost a job or taken a cut in pay because of the outbreak, higher than Millennials (40 percent), Gen X'ers (36 percent), or Baby Boomers (25 percent).[51] Moreover, members of Gen Z were overrepresented in higher-risk service sectors of the economy, making them especially vulnerable to COVID-related shutdowns and curtailment of retail and other service businesses.[52]

Prior to the onset of the Covid pandemic, the overall financial condition of younger households improved in recent years. Although most age groups experienced income gains between 2016 to 2019, those under age 35 experienced the greatest gains, and those between the ages of 35-44 experienced the second-largest gains.[53] Net wealth generally increased more rapidly for younger households during this period as well.[54] Gains were greatest for younger adults with lower education levels. Younger adults also made financial gains during the period from 2013 to 2016 but slightly more modestly.[55]

This recent economic success (prior to the 2020 Covid pandemic) reversed a downward trend from 2001-2013 in net worth among younger consumers.[56] The decline in net worth during this

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[50] *See* Kim Parker and Ruth Igielnik, *On the Cusp of Adulthood and Facing an Uncertain Future: What We Know about Gen Z So Far*, Pew Research Center (May 14, 2020), *available in* https://www.pewsocialtrends.org/essay/on-the-cusp-of-adulthood-and-facing-an-uncertain-future-what-we-know-about-gen-z-so-far/.

[51] Pew Research Center, Worries About Coronavirus Surge, as Most Americans Expect a Recession—or Worse (Mar. 25, 2020).

[52] See Rakesh Kochhar and Amanda Barroso, Young Workers Likely to be Hard Hit as COVI-19 Strikes a Blow to Restaurants and Other Service Sector Jobs, Pew Research Center (Mar. 27, 2020).

[53] *See* Neil Bhutta, Jesse Bricker, Andrew C. Chang, Lisa J. Dettling, Sarena Goodman, Joanne W. Hsu, Keven B. Moore, Sarah Reber, Alice Henrqiques Volv, and Richard A. Windle, *Changes in U.S. Family Finances From 2016 to 2019: Evidence from the Survey of Consumer Finances*, 106(5) Fed. Res. Bulletin 1, at 7 Table 1 (Sept. 2020).

[54] *Id.* at 11, Table 2.

[55] *See* Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, Sarah Pack, John Sabelhaus, Jeffrey Thompson, and Richard A. Windle, *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances*, 103(3) Fed. Res. Bulletin 1 (Sept. 2017).

[56] *See* Lisa J. Dettling and Joanne W. Hsu, *The State of Young Adults' Balance Sheets: Evidence from the Survey of Consumer Finances*, 96 Federal Reserve Bank of St. Louis Review 305 (Fourth Quarter 2014). Although net worth declined during this period for younger adults, it declined less dramatically than for older individuals during this period.

period was most dramatic for higher-educated and higher net worth households. The percentage of younger adults who reported owning homes also declined during this period from 39 percent to 34 percent.[57] Most of the decline in asset values for younger households during this period resulted from declining home values during and after the Great Recession.

12.2.2 Student Loans

Household and Macroeconomic Consequences of Student Loan Debt

Voluminous amounts of research over several decades have shown the potential economic value to individuals from investment in higher education. By enabling high-value investments in human capital formation through education, the opportunity to attend college is highly valuable to consumers. Individuals with more education exhibit higher earnings, more resilience to economic downturns, and higher levels of wealth accumulation than those without higher education.[58] Some evidence indicates that the return to education increased rapidly from the 1970s through the 1990s and then leveled off in the 2000s and has remained steady since at a comparatively high rate of return compared to other investment opportunities.[59] Thus, despite the increasing cost of obtaining a college degree, available evidence suggests that for most people a college degree remains a worthwhile investment of time and money, especially for individuals from relatively disadvantaged groups.[60] Two-thirds of those who graduate with at least a bachelor's degree believe that attending college was worth the cost compared to only 30 percent of those who dropped out.[61] Income and wealth are higher for college graduates than non-graduates, which suggests that the value of the investment exceeded its cost. Homeownership rates among college graduates are higher than those who never attended college, and homeownership rates are similar for college graduates from high-income and low-

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[57] *Id.* at 313. This decline, however, mirrored the decline in homeownership by older households during this period.

[58] *See* Scott A. Wolla and Jessica Sullivan, *Education, Income, and Wealth,* Economic Research Federal Reserve Bank of St. Louis (Jan. 2017), *available in* https://research.stlouisfed.org/publications/page1-econ/2017/01/03/education-income-and-wealth/.

[59] *See* Jason R. Abel and Richard Deitz, *Do the Benefits of College Still Outweigh the Costs?*, 20 Fed. Res. Bank of New York Current Issues in Economics and Finance 7 (2014); Mark C. Long, *Changes in the Returns to Education and College Quality,* 29 Econ. of Education Rev. 338 (2010). According to Abel and Dietz, the average return on a college degree is around 14-15 percent, compared to an average rate of return of 7 percent for stock investments.

[60] *See* Navient, Money Under 35 (2020); Philip Oreopoulos and Uros Petronijevi, *Making College Worth It: A Review of Research on the Returns to Higher Education,* 23 The Future of Children 41 (2013); Douglas Webber, *Is College Worth It? Going Beyond Averages,* ThirdWay.org (Sept. 18, 2018), *available in* https://www.thirdway.org/report/is-college-worth-it-going-beyond-averages; Jaison R. Abel and Richard Deitz, *The Value of a College Degree,* Liberty Street Economics (Sept. 2, 2014), *available in* https://libertystreeteconomics.newyorkfed.org/2014/09/the-value-of-a-college-degree.html.

[61] Board of Governors of the Federal Reserve System, Report on the Economic Well-Being of U.S. Households in 2018 at 37 (May 2019).

income family backgrounds, which indicates that "college attendance appears to mitigate the importance of family background."[62] Overall, students who graduate from college with a Bachelor's degree are substantially more likely to own a home than those who never attend college or receive an Associate's Degree.[63]

Using data from the 2019 Survey of Consumer Finances, Catherine and Yannelis find that the average income for those students who left school with student debt is $97,300 and the median was $71,300, compared to the median income of the full sample of $59,100.[64] Conditional on having educational debt, the average student loan balance was $41,400.

On the other hand, there are others for whom attending college is not a profitable investment.[65] Over the past two decades student loan debt has also emerged as a potential source of household financial stress, particularly for younger Americans. Student loan debt obligations persist for extended periods of time, remaining high for many consumers well into their 40s.[66] Student loan debt is now the second-largest debt holding on American balance sheets, trailing only mortgages, but is the largest single element of non-mortgage consumer debt holdings. As of third quarter 2020, total student loan debt amounted to $1.55 trillion, auto loan debt was $1.36 trillion, and credit card debt was $0.81 trillion (i.e., $810 billion).[67]

Student loan indebtedness is "top heavy" and unevenly distributed among American households. About 30 percent of undergraduate students graduate with no debt and about 25 percent have less than $20,000.[68] Only 5 percent of borrowers had more than $100,000 of debt in 2016, but they accounted for about 30 percent of total student loan debt. Catherine and

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[62] *See* Raji Chakrabarti, Andrew Haughwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, Federal Reserve Bank of New York Press Briefing on Household Debt, with Focus on Student Debt 44 (Apr. 3, 2017), *available in* https://www.newyorkfed.org/medialibrary/media/press/pressbriefing-household-student-debt-april32017.pdf.

[63] *See id.* at 40.

[64] Sylvain Catherine and Constantine Yannelis, *The Distributional Effects of Student Loan Forgiveness*, NBER Working Paper 28175, http://www.nber.org/papers/w28175 (Dec. 2020).

[65] *See* Jaison R. Abel and Richard Deitz, *College May Not Pay Off for Everyone*, Liberty Street Economics (Sept. 4, 2014), *available in* https://libertystreeteconomics.newyorkfed.org/2014/09/college-may-not-pay-off-for-everyone.html (finding that the lowest 25 percent of college graduates earn a comparable income as the median high school graduate wages).

[66] *See* Federal Reserve Bank of New York, Student Loan Debt by Age Group (Mar. 29, 2013).

[67] Federal Reserve Bank of New York, Non-Housing Debt Balance, Newyorkfed.org, https://www.newyorkfed.org/microeconomics/hhdc.html.

[68] *See* Adam Looney, Devis Sessl, and Kadija Yilla, *Who Owes All that Student Debt? And Who'd Benefit if it were Forgiven?*, Brookings.edu (Jan. 28, 2020), *available in* https://www.brookings.edu/policy2020/votervital/who-owes-all-that-student-debt-and-whod-benefit-if-it-were-forgiven/.

Yannelis find that conditional on having student loan debt the average student loan balance in the Survey of Consumer Finances was $41,400.[69] Many high-balance borrowers attended graduate school where they accumulated large balances.[70] In general, both the number of consumers with student loans and their student loan balances upon graduation have been increasing over time.[71] Between 2005 and 2015 student loan balances owed at graduation increased by about 70 percent.

During the past decade, student loan balances are also higher for those living in Black-majority zip codes than in White zip codes; although, they were similar prior to that period.[72] According to Catherine and Yannelis, per capita student loan debt (including both households with student loan debt and those without) is highest for Blacks ($10,630), with Whites second ($6,157), and Hispanics and others holding the lowest balances ($3,996).[73]

As shown in Figures 12-1 and 12-2, student loan debt has grown dramatically in recent decades, overtaking credit cards and auto loans as the largest non-mortgage debt obligation on household balance sheets.

FIGURE 12-1: HOUSEHOLD DEBT HOLDING BY CATEGORY[74]

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69 *See* Catherine and Yannelis, *supra* note 64, at 8.

70 *See* Chakrabarti, Et al., *supra* note 62, at 20.

71 *Id.* at 21.

72 Andrew Haughwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, *Just Released: Racial Disparities in Student Loan Outcomes*, Liberty Street Economics (Nov. 13, 2019), *available in* https://libertystreeteconomics.newyorkfed.org/2019/11/just-released-racial-disparities-in-student-loan-outcomes.html.

73 Catherine and Yannelis, *supra* note 64, at 12.

74 Source: Federal Reserve Bank of New York.

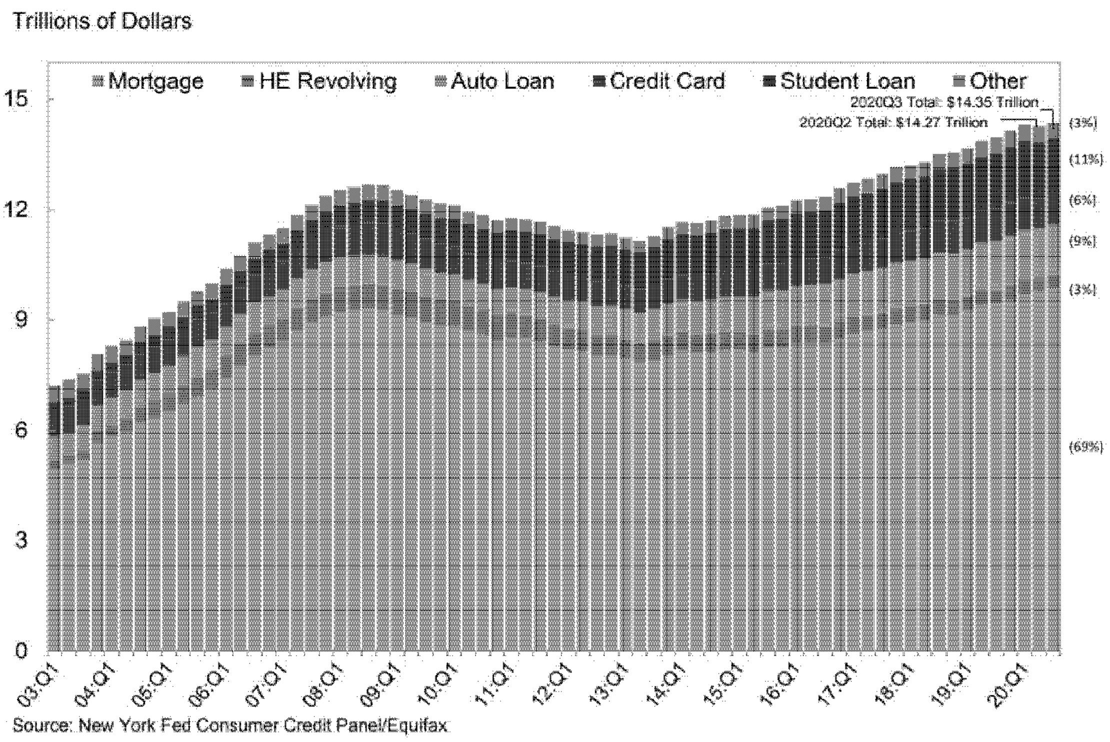
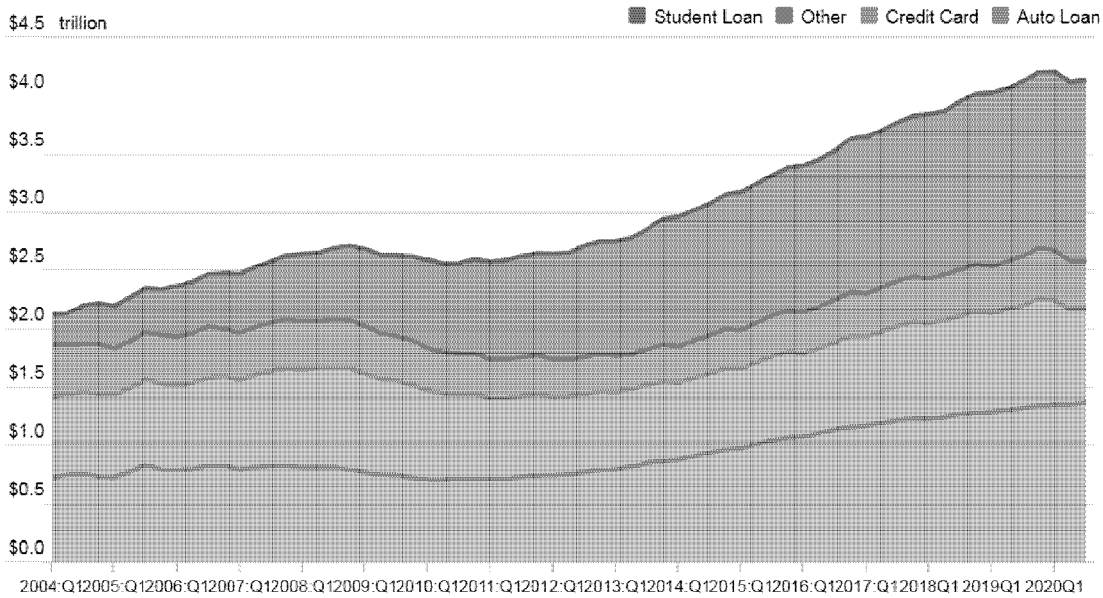


FIGURE 12-2: HOUSEHOLD DEBT HOLDING BY CATEGORY, CONSUMER NON-MORTGAGE DEBT[75]

[75] Source: Federal Reserve Bank of New York.

Non-Housing Debt Balance



Of possible concern beyond the direct cost and impact of student loans is the spillover effect of student debt burdens on young Americans' overall financial condition. A particular area of focus has been the question of whether student loan debt has restricted access to home ownership.

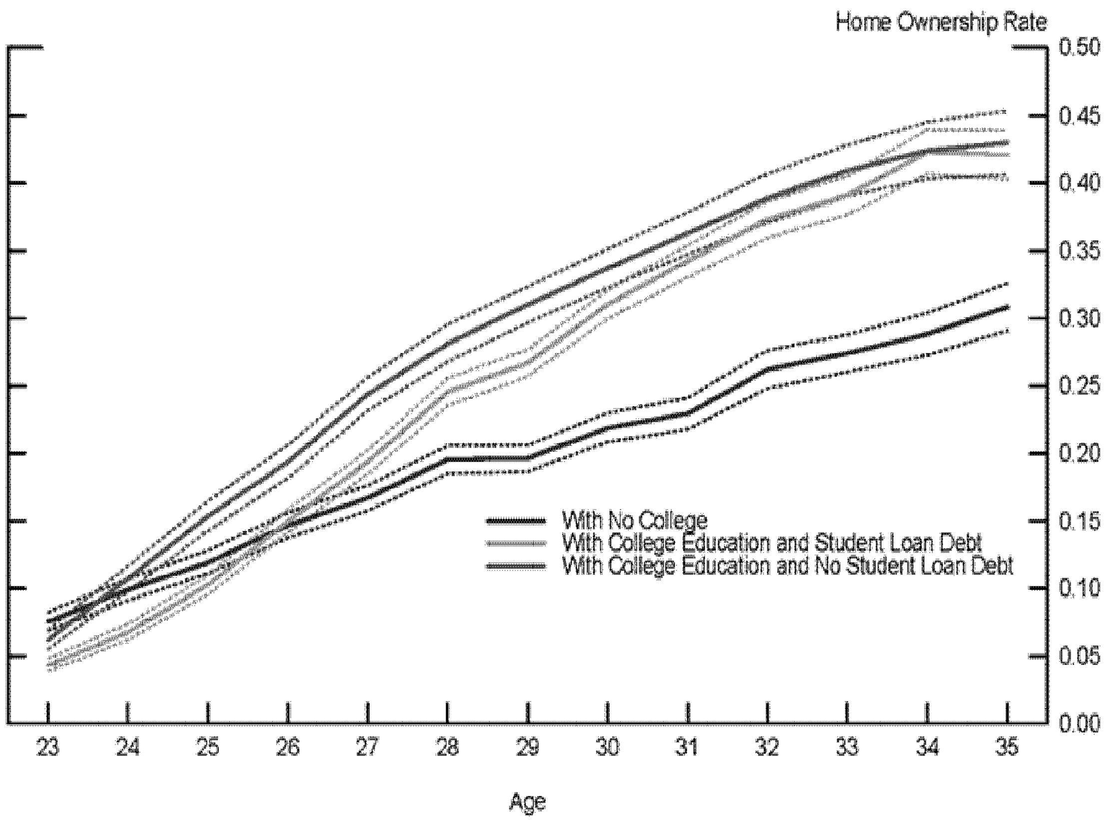
Research by Federal Reserve economists estimated that a 10 percent increase in student loan debt causes a 1 to 2 percentage point drop in the homeownership rate for student loan borrowers during the first five years after exiting school.[76] This negative relationship between college debt and homeownership appears to be only a short-run phenomenon.[77] Those with no college education and those with college education and no student loan debt enter homeownership earlier, on average, than those with college education and student loan debt. By about five years after graduation (age 26), the home ownership rate of those with a college education catches up and then surpasses those with no college education. By age 30, the home-ownership rate of those with college education and student loan debt begins to catch up to college-educated individuals with no debt; and by age 34, their home ownership rates are essentially identical. Taken together, these results suggest that for those with college education,

[76] *See* Alvaro Mezza, Daniel Ringo, Shane Sherlund, and Kamila Sommer, *On the Effect of Student Loans on Access to Homeownership*, Federal Reserve Board (Mar. 2, 2016).

[77] Alvaro Mezza, Kamila Sommer, and Shane Sherlund, *Student Loans and Homeownership Trends*, FEDS Notes (Oct. 15, 2014), *available in* https://www.federalreserve.gov/econresdata/notes/feds-notes/2014/student-loans-and-homeownership-trends-20141015.html.

student loan debt more likely affects the timing of homeownership more than their eventual attainment of it.

FIGURE 12-3: EFFECTS OF STUDENT LOAN DEBT ON HOMEOWNERSHIP RATES



Other research has suggested that there might be similar effects on the relationship between student loan debt with other measures of financial well-being, such as automobile loans and individual credit scores.[78] This data, however, does not distinguish between consumers who have no student loans because they did not attend college versus those who went to college but had no student loan debt. In short, more research is needed to determine the extent to which student loan debt is having adverse spillover effects on consumer balance sheets and the effects of student loan debt on overall household financial maturation.

[78] Meta Brown and Sydnee Caldwell, *Young Student Loan Borrowers Retreat from Housing and Auto Markets*, Liberty Street Economics (Apr. 17, 2013), *available in* https://libertystreeteconomics.newyorkfed.org/2013/04/young-student-loan-borrowers-retreat-from-housing-and-auto-markets.html.

It is not clear what might explain why the dual findings that the presence of student loans is correlated with a reduced frequency of homeownership for the first five years out of college but positively correlated later. One possibility is that high student loans increase a mortgage applicant's debt-to-income (DTI) ratio, pushing it above the permitted threshold to receive a conventional mortgage. Most mortgage lenders prefer a DTI of less than 36 percent to approve a mortgage. Moreover, under federal law and regulations adopted in the wake of the 2008 financial crisis, most lenders will not approve a mortgage with a DTI of greater than the 43 percent, as provided by Regulation Z's "Qualified Mortgage Definition" and "Mortgage-Ability-To-Repay" rules[79] unless the mortgage can qualify under the Temporary GSE qualified mortgage exception[80]. As income rises and student loan debt balances are paid down, however, it might be that one's DTI declines sufficiently to qualify.[81] Higher student loan debt might also make it more difficult to save for a sizeable downpayment, thereby delaying one's ability to purchase a home until that point is reached.[82]

Student loan debt also might temporarily reduce demand for home ownership by recent graduates who move back home to live with their parents after graduation because they cannot afford to live on their own or prefer to live at home and pay down their student loans.[83] Because marriage and family-formation is often a predicate step to home buying, to the extent the presence of student loan debt delays the timing of those life events it would also be expected to delay home buying as well.[84] It has also been suggested that those with student loan debt might self-select not to purchase a house until they feel like they have their student loans somewhat under control, rather than taking on an additional debt obligation.

79 Bureau of Consumer Financial Protection, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z), 12 C.F.R. Part 1026, Fed. Reg., Vol. 84, No. 147 (July 31, 2019). 37156.

80 Bureau of Consumer financial Protection, Ability-to-Repay and Qualified Mortgage Assessment Report (Jan. 2019).

81 An additional challenge is that different federal mortgage programs apply different approaches for dealing with income-based repayment plans. *See* Kristin Blagg, Laurie Goodman, and Kelia Washington, *All Five Federal Mortgage Programs Should Treat Student Loan Debt the Same Way,* Urban Institute (Jan. 15, 2020).

82 *See* Mark Andrew, *The Changing Route to Owner Occupation, the Impact of Student Debt,* 25(1) Housing Studies 39 (2010) (finding that the presence of student loan debt lengthened the time to save for a downpayment by two years).

83 *See* Zachary Bleemer, Meta Brown, Donghon Lee, and Wilbert van der Klaauw, *Tuition, Jobs, or Housing: What's Keeping Millennials at Home?,* Federal Reserve Bank of New York Staff Reports, Staff Report No. 700 (rev. July 2017).

84 *See* Robert Bozick and Angela Estacion, *Do Student Loans Delay Marriage? Debt Repayment and Family Formation in Young Adulthood,* 30 Demographic Research 1865 (2014). The authors conclude an increase of $1,000 in student loan debt is associated with a reduction in the odds of a first marriage by 2 percent a month among female bachelor degree recipients during the first four years after college graduation, but that the effect attenuates over time.

Regardless of the reason why there might be a relationship between student loan debt, homeownership, marriage, and other behaviors, the best evidence to date suggests that the primary effect of student loan debt is to delay homeownership and other indicia of financial maturation, not to stop it completely.[85] As those with student debt age, they appear to follow the traditional financial lifecycle of prior generations, starting off their lives as borrowers before transitioning in middle age to a status as lenders and furnishers of financial capital through bank accounts and financial investments. As student loan debt continues to increase, however, it bears intense monitoring by policymakers and consideration of sensible ways to address problems that might develop over time.

All of this raises an obvious question: Why has student loan debt increased so dramatically over time and especially in the past decade? The answer seems equally obvious: College costs have risen equally dramatically during that same period. Less obvious, however, is the explanation for *why* college costs have risen so much over time.

The cost of attending college has risen dramatically over time and the rate of change of college costs has far outpaced inflation for decades and has increased faster than virtually any other class of ubiquitous goods or services in the economy. According to Bureau of Labor Statistics, from 1980-2014 average college tuition increased by 260 percent compared to a 120 percent increase in the consumer price index.[86] In addition, tuition and other college costs have increased for all types of institutions, regardless of whether they are private or public institutions.[87] Multiple explanations have been provided for why college costs have risen so much over time, but canvassing those theories goes beyond the contours of the Taskforce's charge. Properly understanding the underlying causes of increased college costs, however, is an essential element of understanding the student debt problem and to ensure that government policy interventions do not have unintended consequences that will exacerbate the underlying problem of rising college costs.

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85 *See* Claire Callender, KC Deane, Ariane de Gayardon, and Stephen L. DesJardins, *Student Loan Debt: Longer-Term Implications for Graduates in the United States and England*, *in* Changing Higher Education for a Changing World 101, 108 (Claire Callender, William Locke, and Simon Marginson eds., 2020).

86 *See* Abby Jackson, *This Chart Shows How Quickly College Tuition has Skyrocketed since 1980*, Business Insider (Jul 20, 2015), *available in* https://www.businessinsider.com/this-chart-shows-how-quickly-college-tuition-has-skyrocketed-since-1980-2015-7#:~:text=The%20average%20annual%20increase%20in,to%20the%20Department%20of%20Education.

87 *See* National Center for Education Statistics, Tuition Costs of Colleges and Universities, https://nces.ed.gov/fastfacts/display.asp?id=76; *see also* Briana Boyington and Emma Kerr, *20 Years of Tuition Growth at National Universities*, USNews.com (Sept. 17, 2020), *available in* https://www.usnews.com/education/best-colleges/paying-for-college/articles/2017-09-20/see-20-years-of-tuition-growth-at-national-universities.

Student Loan Default and Delinquency

UNDERSTANDING STUDENT LOAD DEFAULT AND DELINQUENCY

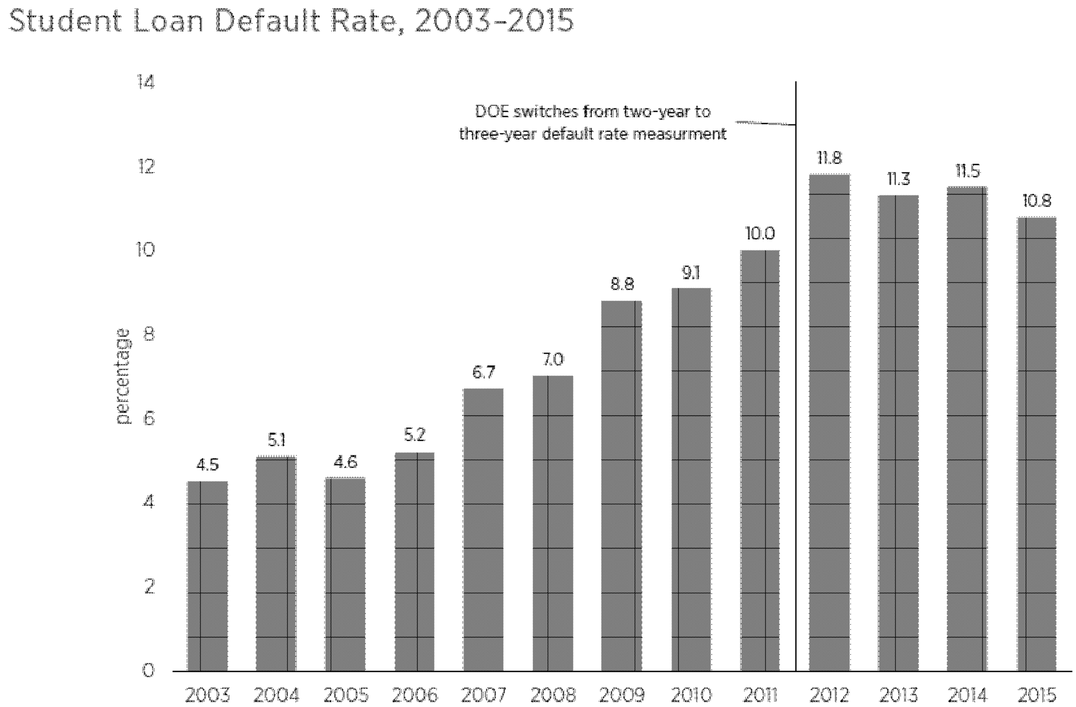
Although student loan debt is only the second-largest category debt on the household financial balance sheet behind mortgages, student loans claim first place with respect to the amount of balances that are delinquent and in derogatory status, having passed mortgages and credit cards several years ago.[88] Default rates in Black-Majority areas are also higher than default rates in White neighborhoods.[89]

Figure 12-4 shows that default rates on student loans rose doubled from 2004 to 2011. Beginning in 2012, the Department of Education switched from a two-year to a three-year default rate measurement, as required by the Higher Education Opportunity Act of 2008, resulting in a one-time discrete jump in reported student loan default rates.

[88] *See* Andrew F. Haughtwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, *Just Released: Mind the Gap in Delinquency Rates*, Liberty Street Economics (Aug. 13, 2019), *available in* https://libertystreeteconomics.newyorkfed.org/2019/08/just-released-mind-the-gap-in-delinquency-rates.html.

[89] Andrew Haughwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, *Just Released: Racial Disparities in Student Loan Outcomes,* Liberty Street Economics (Nov. 13, 2019), *available in* https://libertystreeteconomics.newyorkfed.org/2019/11/just-released-racial-disparities-in-student-loan-outcomes.html.

FIGURE 12-4: STUDENT LOAN DEFAULT RATE[90]

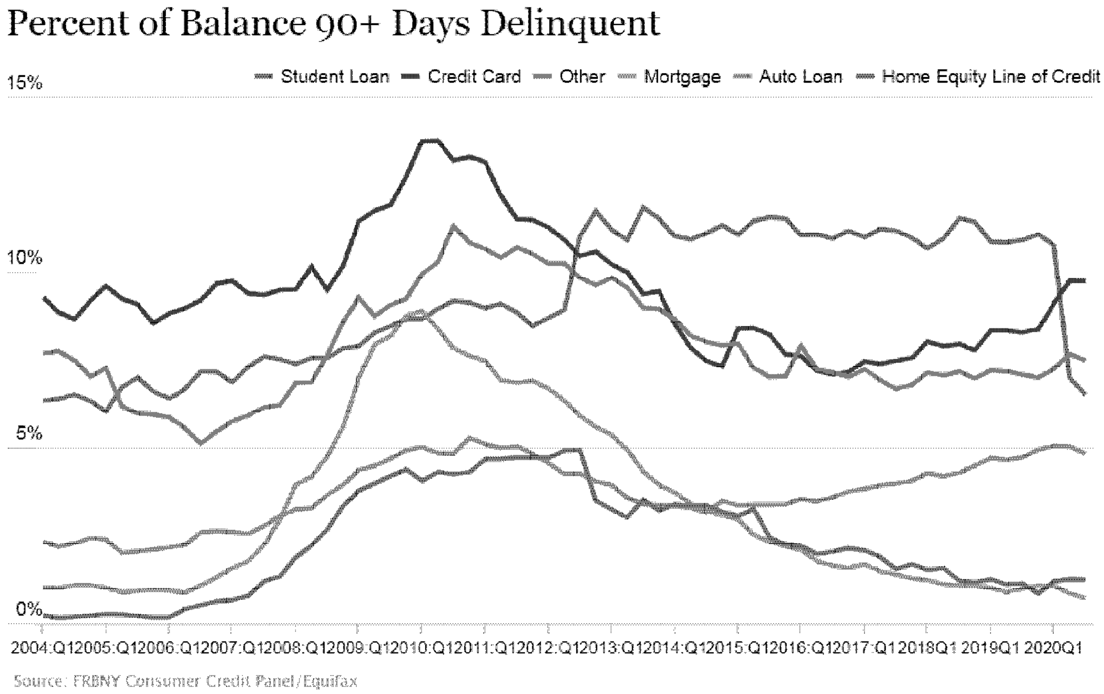


Since then, default rates have remained relatively constant and have stabilized at a rate much higher than the delinquency rates on other types of consumer loans—except for a temporary drop in reported delinquencies as a result of pandemic-related collections and reporting forbearance beginning in the second quarter of 2020—as shown in Figure 12-5.[91]

90 Chart appears in Veronique de Rugy and Jack Salmon, *Reevaluating the Effects of Federal Financing in Higher Education*, Mercatus Center Policy Brief 3, Fig. 2 (Aug. 2019). Source: US Department of Education, "Student Loan Default Rates," September 27, 2017, https://www.ed.gov/category/keyword/student-loan-default-rates.

91 *See* New York Federal Reserve Bank, Household Debt and Credit Report (Q2 2020): Percent of Balance 90+ Days Delinquent, *available in* https://www.newyorkfed.org/microeconomics/hhdc.html.

FIGURE 12-5: DELINQUENCY RATES ON CONSUMER DEBT[92]



Simply because a student loan is not delinquent or in default, however, does not necessarily mean the individual is paying it off. According to the New York Federal Reserve Bank using data from 2014, only 37 percent of student loan borrowers were current on their student loan and actively paying it down at that time.[93] Thirty-three percent of student loans were current but the balance was *increasing* (presumably because they were enrolled in an income-based repayment plan), 13 percent were listed as current but with the same balance due, and 17 percent were listed as delinquent or in default. Defaults and delinquencies were centered in lower-income areas, where about 2/3 of borrowers were having some sort of payment difficulties compared to 1/3 of borrowers from higher income areas.[94] At that time, borrowers from the lowest income areas had made almost no progress paying down their loans: five years after leaving school the aggregate balance of consumers in lower-income areas was still 97 percent of the amount when

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[92] Source: Federal Reserve Bank of New York.

[93] *See* Andres Haughwout, Donghoon Lee, Joelle Scally, Wilbert van der Klaauw, *Student Loan Borrowing and Repayment Trends, 2015*, at p. 27, Federal Reserve Bank of New York (Apr. 16, 2015), *available in* https://www.newyorkfed.org/medialibrary/media/newsevents/mediaadvisory/2015/Student-Loan-Press-Briefing-Presentation.pdf.

[94] *Id.* at 30.

they left school compared to borrowers from higher-income areas, who have paid down nearly 30 percent of their balances.[95]

Most analyses of the causes of student loan default are based on descriptive statistics, not multivariate regressions, and data availability has been limited. As a result, drawing firm conclusions about the causes of student loan defaults and the relative contribution of different possible factors has proven elusive. Available research to date, however, has identified three factors that seem to be particularly important in predicting default and delinquency on student loans: (1) Demographics and (2) Degree Completion, and (3) Post-Graduation Income. Research has also suggested that other factors that might be expected to affect default, such as amount of indebtedness, type of school attended (controlling for demographic characteristics and student quality), or one's college major, appear to have little or counterintuitive predictive effect on student loan defaults after controlling for other factors. Better data and more rigorous multivariate analysis would be welcome to identify the factors relevant to predicting default and considering policy interventions to address those challenges.

Default on student loans is correlated with certain demographic characteristics of the borrower.[96] Factors such as whether the student was from a low-income background, minority status, financial independence, male sex, being a first-generation college student, older age at the time of attending college, and whether the student is also a parent while attending school, are relevant factors correlated with an increased likelihood of default on student loans. Student loan default rates are higher for borrowers with lower credit scores.[97] As summarized in a literature review that examined the causes of student loan default, "It is axiomatic that there is greater risk of default in providing loans to low- and moderate-income students—who often come from families with weak credit histories and who may be at greater risk of not graduating or of ending up in jobs with lower incomes."[98] Another summary concluded, "Defaulters are more likely to be older, be Pell Grant recipients, and come from underrepresented backgrounds than those who never default."[99]

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95 *Id.* at 32.

96 *See* Jacob P.K. Gross, Osman Cekic, Don Hossler, and Nick Hillman, *What Matters in Student Loan Default: A Review of the Research Literature*, 39 J. of Student Financial Aid 19 (2009).

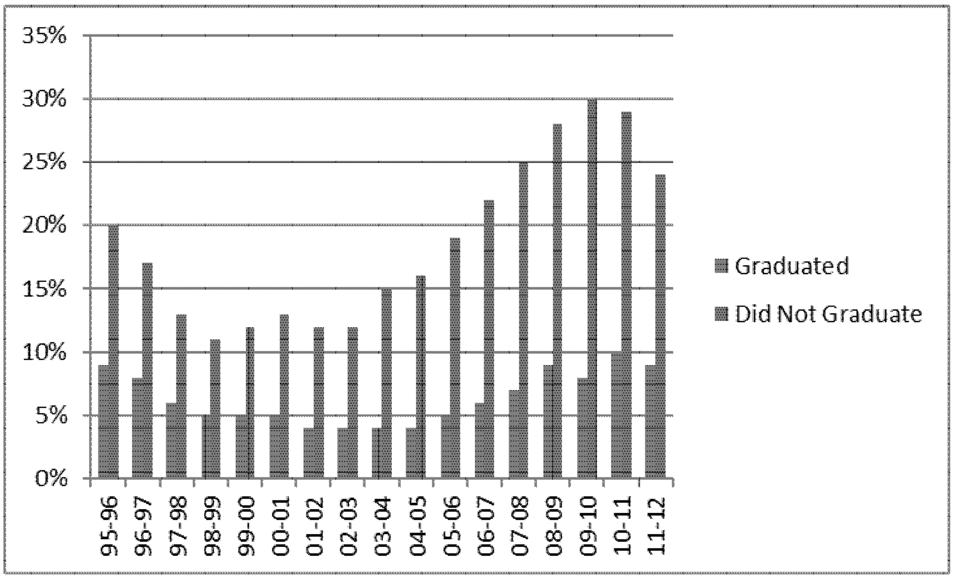
97 Alvaro Mezza and Kamila Sommer, A Trillion Dollar Question: What Predicts Student Loan Delinquency Risk?, FEDS Notes (Oct. 16, 2015).

98 *Id.* at 27.

99 Ben Miller, *Who Are Student Loan Defaulters?* Center for American Progress (Dec. 14, 2017); *see also* Ben Miller, *The Continued Student Loan Crisis for Black Borrowers*, Center for American Progress (Dec. 2, 2019).

Whether a student completes their degree program is a second important factor associated with student loan default rates.[100] Those who complete their course of study and receive a degree are much as three to four times less likely to become delinquent on their student loan obligations than those who drop out.[101] However, the propensity to complete one's course of study and receive a degree is also correlated with many of the same demographic factors that independently predict repayment success; thus, it is not clear the extent to which degree completion is an independent predictor of repayment success.[102] As shown in Figure 12-6, there is a dramatic difference in loan default rates between those who complete their course of study and those who do not.

FIGURE 12-6: DEGREE COMPLETION AND LOAN DEFAULT.[103]



Controlling for student demographic characteristics and the school's student selectivity, the type of educational institution (four-year public, four-year private, community college, or for-profit

[100] *See* Dora Gicheva and Jeffery Thompson, *The Effects of Student Loans on Long-Term Household Financial Stability,* working paper (Oct. 18, 2013), *available in* https://www.urban.org/sites/default/files/2015/01/06/effects-of-student-loans-on-long-term-household-financial-stability.pdf; Michael Itzkowitz, *Want More Students to Pay Down Their Loans? Help Them Graduate,* Third Way (Aug. 8, 2018), *available in* https://www.thirdway.org/report/want-more-students-to-pay-down-their-loans-help-them-graduate; Mezza and Sommer, *supra* note 97.

[101] *See* Mezza and Sommer, *supra* note 97.

[102] *See* William G. Bowen, Matthew M. Chingos, and Michael S. McPherson, Crossing the Finish Line: Completing College At America's Public Universities (2009).

[103] Source: The College Board.

college) that a student attends does not have a discernible effect on default rates.[104] Highly selective colleges have lower student loan default rates than less selective colleges in large part because selective institutions attract students who are better prepared, more likely to graduate, and who are more likely to be employed with higher income after graduation.[105] Community colleges and for-profit schools, by contrast, are typically nonselective in their student bodies, tend to attract students with at-risk demographic characteristics as described above, and as a result, have higher default rates than selective colleges but similar default rates to each other.[106] In addition to drawing a particularly large number of borrowers from higher-risk backgrounds, those who attend for-profit colleges also tend to have lower credit scores at the time of entering repayment.[107] Graduates of more selective colleges and graduate schools also have, on average, much higher post-graduation earnings and lower unemployment rates than graduates of community colleges and for-profit schools, which makes debt repayment easier even with higher debt loads.[108].

Higher post-graduate income is correlated with a lower risk of student loan default but loan balances are *inversely* related, i.e., those with the *largest* loan balances also have the *lowest* default rates and vice-versa.[109] Although it may seem surprising that those who borrow more are less likely to experience repayment difficulties, those who borrow the most usually also completed their degree at a quality institution and usually also attended graduate school,

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[104] See Adam Looney and Constantine Yannelis, A Crisis in Student Loans? How Changes in the Characteristics of Borrowers and the Institutions They Attend Contributed to Rising Loan Defaults, Brookings Papers on Economic Activity 1, 58 (Fall 2015) ("Looking across columns, the association between school types and default drops when individual characteristics are included, which suggests that the school type indicators are capturing unobserved student-specific factors.").

[105] *Se id.* at 35; Rajashri Chakrabarti, Nicole Gorton, Michelle Jiang, and Wilbert van der Klaauw, *Who is More Likely to Default on Student Loans?*, Liberty Street Economics (Nov. 20, 2017), *available in* https://libertystreeteconomics.newyorkfed.org/2017/11/who-is-more-likely-to-default-on-student-loans.html

[106] *See* Looney and Yannelis, *A Crisis in Student Loans?*, *supra* note 104, at 34; *see also* Jason Delisle, *The Left Gives Community Colleges Another Free Pass for Unpaid Student Loans*, AEIdeas (Aug. 29, 2018), *available in* https://www.aei.org/education/the-left-gives-community-colleges-another-free-pass-for-unpaid-student-loans/.

[107] Mezza and Sommer, *supra* note 97.

[108] Looney and Yannelis note that in 2013 the median borrower from a for-profit school had a 21 percent chance of being unemployed, had a median salary of $20,000, and a median loan balance of $10,500. Comparable community college borrowers had a 17 percent chance of being unemployed, a median income of $23,000, and $9,600 in median student debt. *See* Looney and Yannelis, *A Crisis in Student Loans?*, *supra* note 104, at 38. *See also* Robert Clifford, *Student-Loan Debt, Delinquency, and Default: A New England Perspective*, Federal Reserve Bank of Boston New England Public Policy Center Research Report 16-1, at p. 10, Fig. 6 (Sept. 2016); Looney and Yannelis, *Crisis*, *supra* note 104, infographic, *available at* https://www.brookings.edu/wp-content/uploads/2015/12/Chart2_LooneyYannelis_StudentLoanDefaults.png (showing slightly higher default rates for community college borrowers than for-profit colleges and both types having much higher default rates than four year colleges).

[109] *See* Mezza and Sommer, *supra* note 97; Miller, *Student Loan Defaulters*, *supra* note 99 ("In almost every case, the median loan defaulter owed thousands of dollars less than their peers who did not default.").

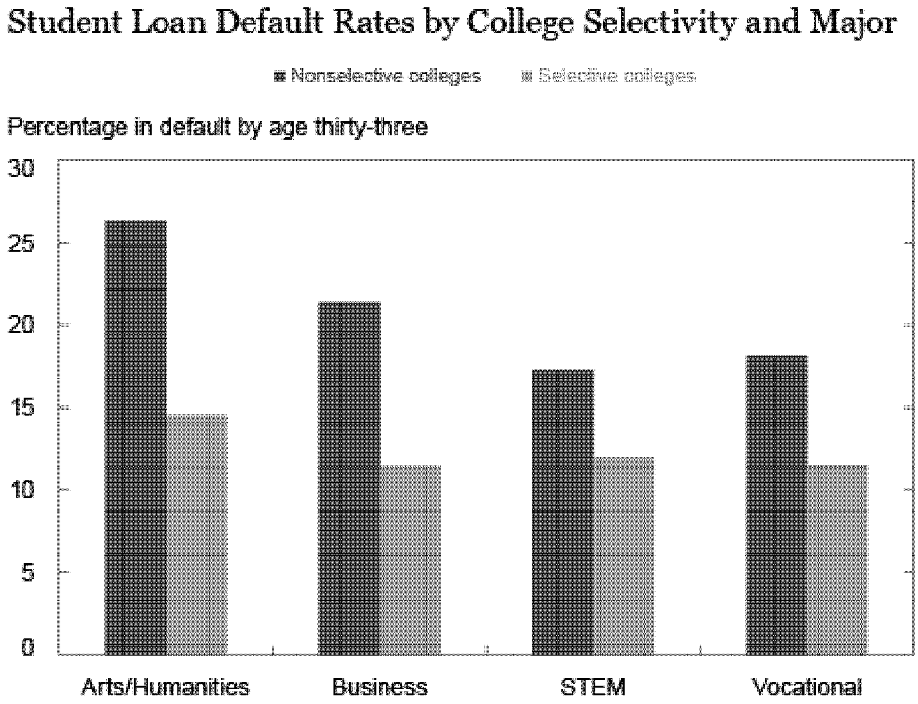
resulting in higher income employment and greater repayment capacity. As observed by Looney and Yannellis, "Traditional borrower tend to have higher incomes than the general population and to owe larger loan balances. Even traditional borrowers with large balances tend to do well, on average, mainly because they acquired their loan balances while attending selective schools or graduate and professional programs."[110] Those with lower debt balances, by contrast, are less likely to have completed their degree.

One's major generally matters less than whether a student attended a selective or nonselective college. For students who attend a selective college, major appears to matter little, as default rates are similar regardless of major field of study. For those who attend nonselective colleges, however, those who studied STEM subjects or vocational training have lower default rates than students who studied Arts and Humanities.[111] Thus, for selective institutions, even though there are documented differences in earnings depending on one's major in college, it may be that the difference in earnings from pursuing one major instead of another is a smaller factor in predicting default than whether the borrower attended a selective institution.

[110] *See* Looney and Yannelis, *supra* note 104, at 64; *See* Adam Looney and Constantine Yannelis, *Borrowers with Large Balances: Rising Student Debt and Falling Repayment Rates*, Brookings Institution (Feb. 2018).

[111] *See* Looney and Yannelis, *supra* note 104.

FIGURE 12-7: STUDENT LOAN DEFAULT RATES BY COLLEGE SELECTIVITY AND MAJOR[112]



Sources: New York Fed Consumer Credit Panel/Equifax; National Student Clearinghouse.

Notes: The chart shows the percentage of college-goers with student loans who have ever defaulted by age thirty-three. "College selectivity" classifications are based on rankings by *Barron's*, which considers an institution's acceptance rate, median freshman score on entrance exams (SAT, ACT), and the share of freshmen who ranked at the top of their high school graduating class. *Barron's* ranks colleges into six categories; we treat those in the top four as "selective."

Overall, there is a shortage of multivariate analysis of the causes of student loan defaults to control for these interrelated characteristics of demographics, credit score, completion rates, selectivity of institution, and other factors that are relevant to predict defaults. Looney and Yanellis aptly summarize the complex interrelationship of these factors, "Regression analysis suggests that nontraditional borrowers experience higher rates of default in part because they are drawn from more disadvantaged backgrounds. For instance, nontraditional borrowers were older, more likely to be independent of their parents, from lower-income families, and living in more disadvantaged areas. They borrowed substantial amounts to attend institutions with low completion rates and, after enrollment, experienced poor labor market outcomes that made their debt burdens difficult to sustain."[113] For policy purposes, the challenge is that marginal and

[112] Source: New York Federal Reserve Bank

[113] Looney and Yannelis, *supra* note 104, at 63.

at risk-borrowers are the intended beneficiaries of federal financial aid programs, thus any efforts to tighten student loan underwriting standards would impact these consumers most.

PROPOSALS FOR ADDRESSING STUDENT LOAN DEBT AND DELINQUENCY

Available evidence indicates that although the growth and burden of student loan debt has not become an overwhelming burden for the economy as a whole, it nevertheless is a matter of concern and extremely troubling in many specific instances. Although the largest debts overwhelmingly are held by those who graduated from selective institutions and graduate schools, there are some unfortunate individuals who have high debts despite low incomes or other issues that affect their ability to repay. Student loan relief programs can be complicated, cumbersome and not always effective at reducing the burden. As noted, some of the more problematic side-effects associated with student loan debt (such as making it more difficult to buy a house) appear to be largely short-term in nature. It is not clear how one should weigh this effect of real, but temporary, financial hardship from student loan debt for some borrowers or the extent to which student loan debt should be examined differently from other types of consumer debt that is incurred to finance a valuable household investment, such as a home car, or consumer durable.

Given the observed correlation between high incomes, high debts, and low default rates, research is divided on the value of student loan relief programs. Some researchers have concluded that student debt relief could have large beneficial economic consequences over the long run by leading to increased opportunities for geographical mobility, job changes, and higher income.[114] Others have doubted the economic benefits of student loan debt relief, noting that relief would provide little in the way of increased monthly cash flow to households and the benefits would be concentrated largely on the highest-earners in the economy who least need relief.[115]

In the course of analyzing the causes and consequences of student loan debt and default, the Taskforce came across certain frequently-discussed proposals to address the burgeoning student loan problem. But based on the Taskforce's review of the evidence, while there are clear benefits associated with each of the proposals, they also could have unintended consequences. Leaving

[114] *See* Marco Di Maggio, Ankit Kalda, and Vincent Yao, *Second Chance: Life Without Student Debt* (Mar. 2, 2020), *available in* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3376245.

[115] *See* Committee for a Responsible Federal Budget, *Canceling Student Loan Debt Is Poor Economic Stimulus* (Nov. 18, 2020), *available in* http://www.crfb.org/blogs/canceling-student-loan-debt-poor-economic-stimulus (estimating that student loan debt cancellation will increase household cash flow by only $90 billion per year at a cost of $1.5 trillion); Jeff Cox, *Erasing Student Debt would be a Small Stimulus but Would Create a "Moral Hazard," Moody's says*, CNBC.com (Nov. 1, 2019), *available in* https://www.cnbc.com/2019/11/01/wiping-out-student-debt-would-be-small-boost-to-economy-moodys-says.html (discussing Moody's Investors Service report that estimates benefits of cancelling student loan debt would add about $86-$108 billion to GDP over a 10 year period).

aside questions about the respective costs and benefits of these programs, the Taskforce offers a few thoughts on factors to consider in deciding whether and how to move forward in developing to student loan policy.

Various policy recommendations have offered a variety of options for dealing with student loan issues. They include widescale loan forgiveness, amending the Bankruptcy Code to permit discharge of student loan debt more easily, or making colleges and universities partially responsible for their student's defaults. In considering any of these interventions, policymakers should be wary to avoid creating a moral hazard problem for colleges and universities that will encourage them to further raise costs or create perverse incentives with respect to administering the student loan program.

Proposals that would either eliminate borrowers' debt through general loan forgiveness or permit discharge of student loans in bankruptcy would tend to provide predominant benefits to those with the highest student loan balances, namely those who attend selective colleges, graduate, and attain higher-income status. Lower default and delinquency status indicates those with larger debts have the least trouble paying their loans and are least likely to default. Proposals for student debt forgiveness or bankruptcy would thus seem to primarily benefit higher income consumers who have the fewest struggles paying their loans, especially those who borrowed to attend graduate school. Reviewing the evidence on full or partial student loan forgiveness, Catherine and Yannelis find that either proposal would be regressive because high earners took larger loans but also because loan values overstate present values for low earners.[116] Overall, they estimate that forgiveness would benefit the top decile as much as the bottom three deciles combined. Debt forgiveness proposals would also have the curious equitable effect of effectively disadvantaging those Americans who chose not to go to college at all, chose to attend a less-expensive school or earned scholarships, worked their way through college, or lived frugally during and after college so as to pay off their student loans after graduation.

Forgiving student loan debt or allowing it to be discharged in bankruptcy could create a moral hazard problem for future college students by encouraging them to borrow more than necessary for college and then to file bankruptcy.[117] One possible compromise would be to cap student loan

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[116] *See* Catherine and Yannelis, *supra* note 64.

[117] There is little evidence on the degree to which allowing student loan discharge in bankruptcy could create moral hazard problems by borrowers in large part because Congress amended the Bankruptcy Code swiftly when the idea first arose. For a summary of the available evidence and the potential limits on their applicability to the current context, *see* Consumer Financial Protection Bureau, Private Student Loans 75-76 (Aug. 29, 2012); *see also See* Rajeev Darolia and Dubravka Ritter, *Strategic Default Among Private Student Loan Debtors: Evidence from Bankruptcy Reform*, 15 Education Finance and Policy 487 (2020). The evidence that exists is not directly analogous to current

forgiveness at some lower amount (such as $5000) that would be targeted to grant relief to those in most danger of default and to provide an equivalent tax credit for those who either never went to college or have paid off their loans.[118]

Of perhaps greater concern is the incentive for moral hazard these proposals would create for colleges and universities. The underlying cause of rising student loan indebtedness is rising college costs. A major contributor to rising college costs has been the growing role of the federal government in providing subsidies to higher education over the past decade, which has essentially instilled a third-party payer system for higher education finance that has enabled universities to raise costs while concealing the full cost of their product. According to a study by economists at the Federal Reserve Bank of New York, approximately 60 cents of every dollar of increased subsidized federal loans and 20 cents on every dollar of unsubsidized student loans is passed through in higher tuition costs to students.[119] This finding suggests that canceling student loan balances either by general fiat or by allowing borrowers easier discharge of student loans in bankruptcy will attenuate any incentives for universities to contain costs because of the ability of student loan borrowers to externalize some of the costs of attending college on other loan recipients or taxpayers through subsequent forgiveness and bankruptcy.

Proposals to require colleges to bear some of the risk of their students' loan performance, often called "skin in the game" proposals, raise concerns of a different type.[120] Under this approach, the colleges and universities that a student attended would be responsible in part or in whole for the debts of students who default. The logic of the approach is that making colleges responsible for student loan repayment performance will provide incentives for colleges to restrain costs and provide more "useful" degrees in order to ensure that their students will obtain remunerative employment upon graduation. But this analysis fails to appreciate the dynamics of student loan default and delinquency described above—the degree to which student loan default rates are correlated with the demographic characteristics of student borrowers (i.e., "at-risk" borrowers),

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proposals because permitting discharge has never been contemplated on this scale before. Permitting consumers to discharge student loans in bankruptcy could lead to the unravelling of the student loan program as a result of this moral hazard and adverse selection as those with the highest. To the extent that it did not lead to unravelling, some borrowers would be incentivized to take on higher levels of debt while in school with the expectation of being able to discharge it in bankruptcy later.

[118] *See* Beth Akers, *Forgive Student Loans, but Only a Little,* Wall St. J. p. A15 (Nov. 23, 2020).

[119] David O. Lucca, Taylor Nadauld, and Karen Shen, *Credit Supply and the Rise in College Tuition: Evidence from the Expansion in Federal Student Aid Programs,* 32 Rev. of Fin. Studies 423 (2019); Looney and Yanellis, *supra* note 104, at 64 (citing studies that conclude that "unqualified aid—particularly aid limited only by costs of attendance—contributes to loan burdens by increasing students' educational costs and their need to borrow").

[120] *See, e.g.,* Carlo Salerno, *Colleges Should Cosign Student Loans,* Inside Higher Ed (June 18, 2019), *available in* https://www.insidehighered.com/views/2019/06/18/congress-should-obligate-colleges-help-repay-students-debt-opinion.

the selectivity of the college, and whether the student graduates with a degree. One predictable response of effectively making colleges "cosigners" or guarantors for their student's debts will be simply to admit fewer lower-income and other at-risk students in the first place, so as to keep down loss rates. This result would be ironic and counterproductive—those are precisely the type of students for whom the student loan program is intended to provide the resources to attend college in the first place. Nonselective colleges that serve marginal students would be unlikely to survive, whereas wealthy selective colleges would be largely unaffected. In addition, colleges would be likely to require students to indemnify them for any losses they would be required to cover, which could prompt more aggressive collection efforts against those students to reduce losses. As Looney and Yanellis observe, "[S]trengthened accountability can reduce defaults. However, such policies have trade-offs, because they may limit the educational opportunities of higher-risk or underserved students. Gauging whether such students (and taxpayers) would be better or worse off from accountability changes or whether policy changes would encourage new and better educational outcomes requires better measures of the returns to educational investments at different institutions."[121]

In raising concerns about these proposals, the Taskforce acknowledges the knottiness of the issue as well as the tradeoffs associated with any chosen course of action. Indeed, the current student loan fiasco is a tale that stretches back decades of unintended consequences that have resulted from trying to make higher education more affordable and accessible, especially to those from backgrounds historically excluded from higher education. Policymakers should be cautious in stepping into this complex web with simple solutions that could backfire with unintended consequences. More generally, today the student loan program is a hybrid of a social welfare program and a loan program, a tension that begs to be resolved at some point.

12.2.3 Technological Adoption, Banking, and Payments

From the dawn of the modern era of consumer finance, the institutions of consumer finance have been in constant change. In the early 20th century, installment sellers emerged to provide capital to the newly urbanized population to finance the purchase of consumer durables and small-dollar lenders, often illegal in nature, offered short-term cash loans to wage earners to meet the challenges of everyday life. In response, financial reformers led by the Russell Sage Foundation supported regulatory reforms to enable small-dollar cash lenders to make legal loans to wage earners. Then the great migration to the suburbs in the post-War era was fueled by an explosion of retail installment credit, automobile loans, and store-branded revolving credit cards. Following the Supreme Court's 1978 decision in *Marquette National Bank of*

[121] Looney and Yanellis, *supra* note 104, at 64.

Minneapolis v. First of Omaha Service Corp.,[122] which authorized national banks in one state to charge its out-of-state credit-card customers the interest rate allowed by its home state, access to credit cards exploded, meeting the needs of a newly mobile and increasingly higher-income society. Abolition of long-standing regulatory restrictions on interstate branch banking catalyzed unprecedented levels of competition and innovation in retail consumer banking services. The late-1990s and early-2000s brought with it the rise of bank-issued debit cards, which quickly became America's favorite non-cash payment device. Formerly popular consumer payment technologies such as personal checks and traveler's checks, which once served valuable and important functions for consumer payments, have been rendered obsolete and replaced with more efficient, secure, and convenient payment mechanisms. Change and innovation to meet consumer demand and the needs of an ever-growing economy has been a constant feature of U.S. consumer finance for the past century.

This dynamic process of change and innovation continues today as the millennial and Gen Z generations emerge into adulthood. In some ways, the preferences and behaviors of these groups reflect a continuity and gradual pace of change with older generations. But in other ways their behavior marks a dramatic break. In addition, some observers suggest that the financial crisis of 2008 and the subsequent Great Recession as a formative moment in shaping the worldview of the Millennial generation, much as the Great Depression shaped the generation that came of age during that traumatic era. At the same time, extraordinary technological innovations are shaking up the traditional delivery channels of consumer financial products but also raising heightened concerns about privacy and security with respect to those same technologies. It will take some time to sort out the full implications of these forces to determine how the consumer financial system will change, but we offer some tentative observations here.

The financial habits of the Baby Boomer generation have been studied for decades and are relatively well understood as they approach retirement age. Baby Boomers set the course for the prevailing consumer financial system. They were the first generation to gain widespread access to credit cards and were in their financial prime of life as debit cards emerged and were seen as a substitute for checks. They have adopted new technologies, such as online banking and mobile payments, with a surprising degree of flexibility. At the same time, checks, cash, and debit cards remain popular with Baby Boomers.[123]

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[122] 439 U.S. 299 (1978).

[123] *See* Reliance Star Payment Services, *Insights into Payment Preferences by Age Groups*, Credit Card Processing Blog (Oct. 6, 2016), *available in* http://www.reliancestar.com/insights-into-payment-preferences-by-age-groups/. American Express cards are especially popular with Baby Boomers, particularly higher income Baby Boomers,

Generation X is sometimes viewed as the "credit card generation" by commentators because of the popularity of credit cards with this generation. Credit cards became widely available early in the financial lifecycle of Generation X consumers and these consumers embraced credit cards as both a transaction and credit vehicle. Generation X was also the first generation to receive intensive marketing touting credit card rewards for shopping and an expectation of avoiding fees for financial services, such as annual fees on credit cards and monthly maintenance fees for bank accounts. Debit cards are also popular with Gen X'ers and this generation has taken up mobile and contactless payments as well as digital wallets.

Contrary to public perceptions that see millennial consumers as a transformative generation, in many ways they exhibit characteristics of a gradual evolution from the behaviors and preferences of Gen X'ers. To be sure, millennials tend to be somewhat more tech-savvy than Generation X, but not radically more so. Having watched Generation X struggle with debt, as embodied in the 2008 mortgage market meltdown, millennials are thought to be wary of taking on excess debt. On the other hand, this apparent aversion to debt may simply reflect the later family formation of millennials and that as they settle down they might adopt more traditional patterns of financial services usage. Moreover, this generation has withstood two financial calamities early in its financial lifecycle: the Great Recession beginning in 2008 which hit just as older millennials were entering the job market. Then just as it seemed the economy had fully recovered from that setback, the Covid pandemic of 2020 hit millennials and Gen Z harder in economic terms than older generations. More than earlier generations, millennials have also entered adulthood with student debt obligations that have shaped their work, living, and consumption habits. These shocks to their job prospects and economic security have shaped millennials in profound ways.

The financial preferences and behaviors of millennials reflect a gradual evolution from earlier generations, not a discrete break with the past. Debit cards are the preferred payment mechanism of millennials with credit cards second.[124] Members of the millennial and Generation X generations are substantially less likely to use cash for transactions than other

because of its perceived prestige. *See* Marie-Louise Dalton, *How do Different Age Groups Prefer to Pay?*, PaymentEye.com (May 3, 2016), *available in* https://www.paymenteye.com/2016/05/03/how-do-different-age-groups-prefer-to-pay/?utm_content=bufferf43a2&utm_medium=social&utm_source=twitter.com&utm_campaign=buffer.

[124] *See* Laura Kim, Raynil Kumar, and Shaun O'Brien, Cash Product Office, Federal Reserve System, 2020 Findings from the Diary of Consumer Payment Choice at 8, Figs. 6-7 (July 2020); Raynil Kumar and Shaun O'Brien, Cash Product Office, Federal Reserve System, 2019 Findings from the Diary of Consumer Payment Choice at 8, Figs. 7-8 (June 2019); *see also* Worldpay Editorial Team, *How Consumer Payment Preferences are Shaping Commerce* (July 10, 2019), *available in* https://www.fisglobal.com/en/insights/merchant-solutions-worldpay/article/how-consumer-payment-preferences-are-shaping-commerce (reporting that millennials are the only generation that prefers debit cards over all other payment types).

generations and their usage of cash is virtually identical with each other.[125] Millennials have also gradually adopted mobile payments and digital wallets, but their uptake of these payment technologies more closely resembles Generation X than Generation Z.[126] General purpose reloadable prepaid cards are also popular with millennials.[127] It is not clear why prepaid cards are so popular with millennials, but one explanation may be that they provide an alternative to bank accounts and credit cards for millennials desiring electronic transactions. Bank accounts have become increasingly expensive for younger consumers following the enactment of the Dodd-Frank financial reform legislation (especially as a result of price controls on debit card interchange fees) and credit cards have become less accessible to younger consumers as a result of the Credit CARD Act of 2009.[128]

Unlike millennials, who appear to be more conventional in their use of financial products, evidence suggests that Generation Z may prove to be a discrete break in kind from the habits of earlier generations. In part this is because of the centrality of mobile devices to their lives but may also reflect a backlash against some of the preferred technologies of earlier generations. Gen Z consumers are the first cohort for which mobile banking is preferred over online banking.[129] Gen Z'ers are especially likely to use digital wallets[130] and to conduct peer-to-peer money transfers.[131] To date, older Gen Z'ers have expressed skepticism toward credit cards and wariness about consumer debt, perhaps as a result of their youth experience living through the Great Recession or awareness of student loan debt. On the other hand, credit card usage tends to increase as consumers age, so it is possible that this generation's aversion to credit cards

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125 *See* Kim, et al., *supra* note 124; Kumar, *supra* note 124.

126 *See* Pew Charitable Trusts, Who Uses Mobile Payments? at 3, Fig. 2 (May 2016) (finding that 39 percent of those who use mobile payments are millennials and 33 percent were Generation Xers); *see also id.* at 5 (finding similar rates of usage by millennials and Generation X consumers in use of mobile payments to make a purchase or pay bills).

127 *See* Abby Hayes, *Why Are Millennials Using Prepaid Cards?*, DoughRoller.com (June 29, 2020), *available in* https://www.doughroller.net/credit-cards/why-are-millennials-using-prepaid-credit-cards/; Reliance Star Payment Services, *Insights into Payment Preferences by Age Groups*, Credit Card Processing Blog (Oct. 6, 2016), *available in* http://www.reliancestar.com/insights-into-payment-preferences-by-age-groups/.

128 *See* discussion in Section II.D., *infra*.

129 See Accenture, According to Accenture: Gen Z Consumers Visit Bank Branches More Often than Any Other Age Group, Including Baby Boomers (Oct. 17, 2017), available in https://newsroom.accenture.com/industries/banking/according-to-accenture-gen-z-consumers-visit-bank-branches-more-often-than-any-other-age-group-including-baby-boomers.htm.

130 *See* Jean Blaney, *Gen Z is Leading the Way to Alternative Payment Options*, Payments Journal (Feb. 20, 2020), *available in* https://www.paymentsjournal.com/gen-z-is-leading-the-way-to-alternative-payment-options/#:~:text=When%20it%20comes%20to%20their,in%20stores%20offering%20contactless%20payments.

131 According to one survey 79 percent of Gen Z reported using peer-to-peer payments at least once per month and they are more likely to use a digital wallet than prior generations. *See Billtrust's Generation Z and Digital Payments Study*, Billtrust.com, *available in* https://www.billtrust.com/resources/blog/billtrusts-generation-z-and-digital-payments-study/.

might attenuate over time. On the other hand, the demise of checks appears inevitable—30 percent of Gen Z and 20 percent of millennials report having never used a paper check in their life.[132]

Today, Generation Z consumers are familiar with various FinTech products and providers and generally sees little difference between providers of tech-based financial services (such as Google, Venmo, or PayPal) and traditional banks in terms of trust or reliability. For example, Generation Z'ers are about equally concerned about fraud when using FinTech versus a traditional financial provider.[133] On the other hand, when asked about receiving banking services from a general tech *company* (such as Google, Microsoft, Facebook, Amazon, or Apple) instead of a specialized FinTech company, Gen Z seems far less comfortable.[134] This growth in mobile wallets, peer-to-peer transactions and other new payment technologies might also have been spurred by regulations that reduced access to bank accounts (because of their increased cost following the enactment of the Dodd-Frank financial reform legislation) and credit cards (because of the effects of the Credit CARD Act of 2009, as discussed below). Thus, the same economic and regulatory forces that prompted increased usage of prepaid cards by millennials might instead be pushing Generation Z toward mobile wallets and FinTech products.

This rapidity of embrace of mobile and digital financial technologies by Generation Z is not surprising. What is surprising, however, is some reports suggest Generation Z is expressing some backlash against what they perceive as the excesses of this recent wave of technological innovation. Members of Generation Z express general concern about issues of privacy and data security in the digital world, a concern that carries over to their usage of financial services. Contrary to earlier generations, Gen Z'ers have been instructed from an early age to be careful about what they share online. They are also more adept at controlling their privacy settings.[135] It is unclear to what extent these factors indicated that Gen Z is more conscious and concerned about privacy than earlier generations, better at protecting their privacy, or some combination of both.

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132 Id.

133 *See* Billtrust, *supra* note 131 (reporting that 60 percent of consumers have the same level of concern about both, 24 percent are more concerned about FinTech providers, and 16 percent are more concerned about traditional providers).

134 *See* Manole Capital Management, *What Gen-Z Thinks About Banks*, SeekingAlpha.com (Jul. 16, 2020), *available in* https://seekingalpha.com/article/4358901-what-gen-z-thinks-banks.

135 *See* Billtrust, *supra* note 131; *see also* Mueller, *Generation Z: Driving the Adoption of Online Cash*, Paysafecard.com (Nov. 4, 2019), *available in* https://www.paysafe.com/en/blog/generation-z-driving-the-adoption-of-online-cash/ (noting that two-thirds of Generation Zers have adjusted the privacy settings on their social media accounts, 75 percent will only allow location sharing if it's necessary for apps to function, and 87 percent consider online privacy to be more important than popularity or "likes").

These concerns about privacy and security may explain an unexpected trend among Generation Z—their continued use of cash. Indeed, recent data reveals that consumers under the age of 25 use cash to conduct a higher percentage of transactions than any other age group, even slightly more than those who are 65 and older.[136] According to a study by Accenture, Gen Z consumers are more likely than any other age group, including Baby Boomers, to visit a bank branch at least weekly, "reflecting the heavy cash dependence within their age cohort."[137] On the other hand, there is a heavily bimodal distribution to branch usage by Gen Z—some visit branches frequently while others do so rarely or not at all.[138] The continued usage of branches may simply reflect the relative youth and financial immaturity of this cohort today—the most common reason why Gen Z visits a branch is to use an ATM (43 percent of respondents) and the second most-common reason is to deposit a check (26 percent).

Because of their youth, Gen Z has limited bank balances and doesn't carry around large amounts of cash in their wallet and thus they tend to make many smaller withdrawals.[139] The desire to visit a branch of one's own bank to use an ATM might reflect the desire to avoid fees from accessing out-of-network ATMs, which average $4.64 for out-of-network transactions, a large amount given the relatively small size and frequency of withdrawals by Gen Z consumers.[140] The use of ATM to deposit checks might reflect similar forces—whereas older consumers receive many of their payments by direct deposit and the like, Gen Z may still receive payments for part-time jobs and gifts from relatives as checks. Although mobile deposit is more convenient than visiting a bank, funds deposited in an ATM or in-person generally are available for use more rapidly than for mobile deposit of a check image, which can take several days to clear and for funds to become available. Reforms that could speed up the availability of funds deposited by mobile deposit could substantially reduce the need for Gen Z to visit the bank to deposit checks.

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136 *See* Kim, *supra* note 124.

137 Accenture, According to Accenture: Gen Z Consumers Visit Bank Branches More Often than Any Other Age Group, Including Baby Boomers (Oct. 17, 2017), available in https://newsroom.accenture.com/industries/banking/according-to-accenture-gen-z-consumers-visit-bank-branches-more-often-than-any-other-age-group-including-baby-boomers.htm.

138 *See* Manole, *What Gen-Z Thinks*, *supra* note 134.

139 *See* Kim, *supra* note 124, at Fig. 9 (reporting that although consumers under the age of 25 make the largest volume of cash transactions they also have the smallest daily holdings of cash).

140 *See* Mathew Goldberg, *Survey: Interest Checking Account Fees Hit Record High, While Average Yield Ties Record Low*, Bankrate.com (Oct. 21, 2020), *available in* https://www.bankrate.com/banking/checking/checking-account-survey/. One contributor to the increase in average ATM fees over the past decade has been the "Durbin Amendment" to Dodd-Frank, which imposed price controls on debit card interchange fees, thereby displacing costs toward higher bank fees and reduced access to free checking but also appears to have contributed to increases in other fees such as ATM fees. *See* Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses* 12-13 (Apr. 25, 2017).

The high level of cash usage by Generation Z consumers is especially surprising in that the millennial generation exhibits the *lowest* level of cash usage, approximately half as much as Generation Z.[141] Indeed, Generation Z consumers are increasingly using a novel innovation known as "online cash" to conduct transactions.[142] Contrary to their perception as entirely digital shoppers, members of Generation Z are comparable to earlier generations in selecting their bank based on convenient access to a branch location and continue to use in-person services at bank branches with a similar frequency to their cohorts in earlier generations.[143] This reinvigoration of cash usage by Generation Z may stem from the value they place on the anonymity of cash usage, reflecting their heightened concern for privacy and security in financial transactions.

This high rate of cash usage by Gen Z might, however, simply reflect their lack of financial maturity rather than their preferences, and as they will reduce their cash usage as they age. The 2020 Covid-19 pandemic appears to have accelerated this transition. According to one survey, 90 percent of Gen Z respondents to a survey conducted during the height of the pandemic in 2020 stated that they did not think it was "safe" to visit a bank branch at that time.[144] Eighty-two percent did not believe that ATMs were a sanity means of banking. Over half stated that they would be willing to consider banking with an entirely branchless bank. It is too early to tell whether these changes will prove permanent.

Paper money itself provides a public health challenge. A study of circulating one dollar bills in New York City collected in 2013 identified 397 species of bacteria.[145] Another study found that 79 percent of one-dollar bills contained traces of cocaine.[146] Coins can also be robust transmitters of bacteria and disease—one study found that penicillin-resistant bacteria can survive on coins.[147] It seems plausible that the 2020 pandemic might make Americans more aware of the risks associated with using paper money. Greater awareness of the health risks

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141 Kim, *supra* note 124.

142 *See* Udo Mueller, *Generation Z: Driving the Adoption of Online Cash*, Paysafecard.com (Nov. 4, 2019), *available in* https://www.paysafe.com/en/blog/generation-z-driving-the-adoption-of-online-cash/.

143 *See* Elliot Anenberg, Andrew C. Chang, Serafin Grundi, Kevin B. Moore, and Richard Windle, *The Branch Puzzle: Why Are there Still Bank Branches?*, FEDS Notes (Aug. 20, 2018).

144 *See* Manole, *What Gen-Z Thinks*, *supra* note 134.

145 Julia M. Maritz, Steven A. Sullivan, Robert J. Prill, Emre Aksoy, Paul Scheid, Jane M. Carlton, *Filthy Lucre: A Metagenomic Pilot Study of Microbes Found on Circulating Currency in New York City*, 12(4) PLOS ONE (2017).

146 Jonathan Oyler, William D. Darwin, Edward J. Cone, *Cocaine Contamination of United States Paper Currency*, 20 J. of Analytical Toxicology 213 (1996).

147 See Emmanouil Angelakis, et al., Paper Money and Coins as Potential Vectors of Transmissible Disease, 9 Future Microbiology 249 (2014).

associated with cash could also prompt reconsideration of state laws and city ordinances passed in some cities that prohibit establishments from adopting policies that prohibit the use of currency and require use of payment cards or contactless payments.[148]

12.2.4 Regulatory Challenges

A particular challenge to younger consumers has resulted from provisions of the Credit CARD Act of 2009 that specifically impact younger borrowers. Title 3 of the CARD Act places limits on the ability of credit card companies to market credit cards to college students and generally prohibits sending preapproved card solicitations to individuals under the age of 21.[149] In order for an issuer to open a credit card account for a consumer under the age of 21, the consumer must either demonstrate an independent ability to pay for the charges on the card or have a co-signer who is at least 21 years old and can demonstrate independent ability to repay or demonstrate a reasonable expectation of access to the income or assets necessary to repay.[150]

The direct effects of the CARD Act have been as intended. Marketing of credit cards to college students has declined since the enactment of CARD Act.[151] In addition, individuals under the age of 21 are less likely to have a credit card at all and those who do have cards have a fewer number on average.[152] Younger consumers are also now more likely to have a co-signed card than before the CARD Act's passage.[153]

But research has identified a variety of adverse unintended consequences of the CARD Act on younger Americans. Responsible access to and use of a credit card early in life has been an important mechanism for many consumers to build a credit experience and a positive credit report that will position them for financial success later. Younger consumers are far more likely than the average American to be considered "credit invisible," that is, lacking a sufficient credit

[148] *See Cash or Credit? State and City Bans on Cashless Retailers Are on the Rise,* National Law Review (June 5, 2020), *available in* https://www.natlawreview.com/article/cash-or-credit-state-and-city-bans-cashless-retailers-are-rise.

[149] 15 U.S.C. §1650(f)(2); 15 U.S.C. § 1681b(c)1)(b).

[150] 15 U.S.C. §1637(c)(8); 12 C.F.R. §1026.51(b)(1).

[151] *See* United States Government Accountability Office, Report to Congressional Committees, Credit Cards: Marketing to College Students Appears to Have Declined (Feb. 2014).

[152] Peter Debbaut, Andra Ghent, and Marianna Kudlyak, *The CARD Act and Young Borrowers: The Effects and the Affected,* 48 J. of Money, Credit, and Banking 1495 (Oct. 2016).

[153] *Id.*; *see also* Bureau of Consumer Financial Protection, The Consumer Credit Card Market 125-27 and 127 Fig. 1 (Aug. 2019).

record to be considered "scorable" by the major credit bureaus.[154] Minority consumers are more likely to be credit invisible than Whites. Moreover, being credit invisible earlier in life has a path-dependent effect, making it more likely that such individuals will remain credit invisible or a "thin file" consumer later in life too. Surveys indicate that the most common reason that consumers state they want a credit card is to build a credit history.[155] According to research by the CFPB on how consumers become "credit visible," more than one-third of previously credit invisible consumers under the age of 25 used a credit card as their "entry product" to becoming credit visible (35.6 percent of respondents), almost double the rate as the second most-common product, student loans (19.9 percent).[156]

Although the CARD Act has likely protected some younger consumers from making mistakes with credit card debt before they turn 21 years old, it has also deprived many other consumers of the opportunity to prove their creditworthiness and start on the path to financial maturation. Younger Americans today are much more likely to graduate from college having never had the responsibility of managing a credit card and instead have their first experience once they are on their own. Preventing consumers from gaining access to credit cards until they are 21 years old might not so much ensure that consumers will not make mistakes but rather might simply delay those mistakes for a few years. Indeed, there is little evidence to support the belief that consumers between the age of 18 and 21 are especially susceptible to irresponsible financial behavior.[157]

A study by economists at the Federal Reserve Bank of Boston confirms the concern that blocking access to credit cards early life increases the likelihood of a consumer remaining credit invisible later.[158] Using data from the New York Fed Consumer Credit Panel provided by Equifax, the authors find "there are indeed fewer young adults in credit bureau data since the implementation of the CARD Act."[159] They further observe that while this effect exists across the board, "This finding appears to be driven at least in part by reduced credit supply to young

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[154] *See* Consumer Financial Protection Bureau, Data Point: Credit Invisibles (May 2015)

[155] *See* The Ascent, *Why Swipe? American Credit Card Preferences and Habits by Generation*, Fool.com (Mar. 5, 2019), *available in* https://www.fool.com/the-ascent/credit-cards/articles/study-why-swipe-american-credit-card-preferences-and-habits-by-generation/.

[156] *See* Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible 13-15 (2017) (retail store cards were the third most common response, with 13.7 percent of respondents).

[157] *See* Debbaut, et al., *supra* note 152, at 1512 ("At present there is thus little evidence that people who get a credit card early in life are particularly vulnerable borrowers, but there is evidence that the restriction on individuals under the age of 21 is not innocuous.").

[158] *See* Daniel Cooper, Olga Gorbachev, and Maira Jose Luengo-Prado, *Consumption, Credit, and the Missing Young*, Federal Reserve Bank of Boston (Aug. 5, 2020).

[159] *Id.* at 3.

individuals of less privileged backgrounds."[160] This differential impact on lower-income and minority consumers appears to result from the CARD Act. Now, younger consumers are relatively more likely to have access to credit cards "if they are in socioeconomic groups deemed historically to be less of a credit risk, or if they have more affluent parents who can co-sign a card for them."[161] As a result, these provisions of the CARD Act have tended to exacerbate differences between demographic groups in their long-term access to financial products and wealth building.

Economic research also has tended to support the view that allowing access to credit cards earlier in life is useful to establish a credit record and to develop positive financial habits that pay off later. Debbaut, Ghent, and Kulyak, for example, conclude that those who obtain a credit card earlier in their financial lifecycle "are less likely to have a serious default and have higher credit scores later in life than those who get a card later."[162] Cooper, et al., find that consumers who turned 21 years old after the passage the CARD Act also were less likely to have access to mortgages and to pay higher mortgage prices than those of the prior generation.[163]

More troubling, a lack of access to credit cards might force younger consumers to turn to more-expensive alternatives to gain access to needed funds, such as payday loans, bank overdraft protection, or personal installment loans.[164] As shown in chapter 5, alternative financial products are more heavily used by credit-rationed younger, lower-income, and minority consumers already and shutting off access to credit cards might further induce higher demand for those products.[165] Secured credit cards are also unattractive or unavailable to younger credit invisible consumers as an entry product to greater credit visibility because of the need to post and hold up-front liquid deposits.[166] Moreover, good performance on credit card accounts can

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160 Id.

161 Id.

162 *See* Debbaut, et al., *supra* note 152, at 1496.

163 Cooper, et al., *supra* note 158, at 12.

164 *See* Gregory S. Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, 34 J. of Fin. Intermediation 109 (2018) (finding substitution by higher-risk consumers to increased use of personal installment loans after the passage of the CARD Act).

165 It is also possible that younger consumers who cannot gain access to credit cards might substitute increased student loan debt instead. The welfare consequences of such a substitution are unclear. Student loans typically feature a lower interest rates than credit cards but also face greater risk as a result of their nondischargeable status in bankruptcy. The Taskforce has located no evidence to determine whether such a relationship exists, but believes further research is warranted.

166 *See* Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible 15 (2017) (noting that fewer than one percent of previously credit invisible consumers under the age of 25 used a secured credit card as an entry product to become credit visible).

help a consumer establish a positive credit score, whereas usage of these substitute products has either no effect or a negative effect on one's credit score. Eliminating access to one source of supply, in this case credit cards, does not eliminate the demand for credit but often just shifts demand to other, less-preferred products.

12.3 Savings and Retirement

As discussed in chapter 3, consumers borrow in order to shift the timing of consumption from a future period to the present. The ability to shift the timing of consumption forward in time is not merely zero-sum, however. Instead, borrowing can be used by households to take advantage of valuable investment opportunities to acquire capital goods, such as education, an automobile, a home, or consumer durables such as appliances and furniture. These goods have both a consumption value and a capital value for consumers as they provide a stream of benefits to the consumer that will usually exceed the cost of the product including the financing costs. In other situations, consumers use debt to cover unexpected emergencies and budget shocks that could lead to damaging consequences, such as to finance a car repair, medical bill, food, or to prevent foreclosure or eviction. By moving spending on large purchases that does not fit conveniently into monthly budgets forward in time, consumers can save for the purchases through loan repayments while simultaneously using the purchases. This obviates the need for expensive substitutes while cash accumulation takes place and provides a preferred time schedule for purchases. For consumers, moving the schedule smooths both consumption and saving over their lifecycles.

By middle age, most Americans begin to transition toward less borrowing. Early in their life cycles, consumers have a high demand for credit in order to finance capital expenditures. But their current income is still low compared to the future and they have yet to compile substantial liquid assets. As individuals form families and take on associated costs, this puts additional strain on their budgets. Eventually, however, their balance sheet tends to turn right-side up and they begin to accumulate asset holdings. At this point consumers move from being net borrowers to being net lenders, i.e., toward *financial* "saving" and "investing."

Through the process of financial intermediation described in chapter 4, consumers convert excess funds into *financial* capital through intermediaries like banks, pension intermediaries, and others. These financial institutions convert them into loanable funds for businesses, governments, and other consumers. As this change from financial borrowing to financial lending occurs, consumers begin to develop a portfolio of financial assets, including demand deposits and short-term liquid savings, retirement investments, and other financial investments to go with their real investments like homes. Many consumers use their peak income earning years to build financial wealth as well as real wealth.

Later in their lives, most Americans retire and stop working and earning income from employment. Just as early in their working lives they were able to use credit to move consumption forward in time from their later years, asset accumulation during working years enables consumers to move consumption from their income-earning years to a later time when they are retired and their income from current employment falls. Financial saving, like earlier net financial borrowing, is simply a way to smooth consumption across the lifecycle by pushing consumption from the present to the future.

But just as there is a cost in the future to shifting income to an earlier time period through borrowing (reducing consumption today to make the payments), there is also a cost to financial saving—again reducing one's consumption today in order to provide for the future. Through the process of financial intermediation, the same people are usually on both sides of this transaction at different periods of their financial lifecycle.

This section reviews the dynamics of the process of financial accumulation, typically called household financial "savings."[167] It includes both long run financial savings (to finance retirement consumption) and short run financial savings (to finance capital investments and meet emergency needs for funds through short-term liquid savings instead of borrowing).

Just as with beliefs about how Americans use consumer credit, there are many myths and misunderstandings about household financial savings. Concern that Americans are spending too much and saving too little is as old as the country itself. Economist Lendol Calder refers to this recurrent opinion as "the myth of lost economic virtue"—the notion that earlier generations of Americans eschewed consumer debt and diligently saved for retirement and major purchases.[168] Writing in 1956 famed social critic William Whyte captured the idea in his iconic "Fortune" magazine essay, "Budgetism: Opiate of the Middle Class."[169] Writing of the abandonment of thrift by the American middle-class, he wrote, "More and more, people are saving not to accumulate but to spend; for no longer do they identify saving, as people once did, with morality. They save little not because they cannot save.... They save little because they do not really believe in saving." Instead of saving for unforeseen emergencies, Whyte complained that

[167] Although technically the term "savings" should also take into account the process of investment in real assets and their depreciation over time, this common terminology of equating "savings" with "financial savings" is adopted here for the present discussion except when the context makes clear otherwise.

[168] Lendol G. Calder, Financing the American Dream: A Cultural History of Consumer Credit (1999).

[169] William H. Whyte, Jr., *Budgetism: Opiate of the Middle Class*, Fortune 133 (May 1956).

"young suburbanites" were saving "for some anticipated expense" and "For short-term emergencies [they] expect to take shelter under personal loans." Clearly, there has long been concern by social commentators that Americans are saving insufficient amounts for emergencies and retirement and instead relying too heavily on debt.

This Section of the chapter reviews current evidence on American savings habits with a particular focus on the adequacy of household's retirement savings. Because of tradeoffs inherent in saving for long-term retirement goals versus short and medium-term goals such as building an emergency reserve fund or for investments in purchasing a home or college education, understanding the dynamics of retirement savings will require understanding those elements of savings as well. Before analyzing those tradeoffs, however, it is necessary to first understand the dynamics of savings behavior.

12.3.1 How Do Consumers "Save"?

"Financial saving" is the shifting of income across time in to the future to smooth consumption across the lifecycle by holding financial assets or liquid funds that can be used to meet unexpected budget shocks in the future without borrowing. By shifting income from today to the future, financial saving leaves less income available today to spend in order to produce greater future income. Saving income today, therefore, tightens the household budget constraint in the short-run in order to better smooth income over the long run.

Because savings today tightens one's current budget constraint, *ceteris paribus* these savings can be financed in only three ways: (1) reduced consumption today, (2) increasing one's income today (by working more and reducing leisure), or (3) by borrowing more today in order to maintain the same level of consumption as would be the case had the household not saved more.[170] All three of these strategies involve substantial opportunity cost in a world of a binding budget constraint. Moreover, a household's level of financial resources is not the only constraint; consumers also face binding constraints on their available time and energy. Just as consumers must allocate their scarce current income across multiple competing expenditures every day, they must also allocate their scarce lifetime income across their lifetimes through borrowing and saving. Once it is recognized that there is an opportunity cost associated with saving, the question of the optimal allocation of income across the financial lifecycle becomes a somewhat challenging issue.

[170] See Todd J. Zywicki, Do Americans Really Save Too Little and Should We Nudge Them to Save More? The Ethics of Nudging Retirement Savings, 14 Georgetown J. of Law and Public Pol'y 877 (2016).

Consume Less Today to Consume More in the Future

Shifting income from today to the future could be financed by reducing consumption today.[171] Yet as has been stressed repeatedly throughout this report, consumption early in the financial lifecycle has a high marginal value, especially in exploiting positive-value non-financial investment opportunities for household capital acquisitions such as an education, home, automobile, and consumer durable goods such as household appliances, furniture, or a professional wardrobe. Starting a family and raising children presents additional budget pressures for increased spending on housing, food, clothing, transportation, housing and eventually higher education. Although financial investments also provide a positive rate of return, it is not obvious that the rate of return on a mutual fund investment or other financial investment is higher than the rate of return on an investment in education[172] or implicit rate of return from the purchase of a household appliance such as a washing machine, automobile, or refrigerator.[173]

As a result, expenditures relative to income are typically much higher early in life than later.[174] Average household spending hits a peak at age forty-five and steadily declines in every category except for healthcare after that.[175] This hump shaped pattern of consumption is driven largely by the financial pressures of family formation and raising children during the first half of adult life and consumption expenditures fall after children leave home.[176]

In addition, consumers have lower income and tighter financial budget constraints early in their financial lifecycle than in middle-age. Thus, at the same time that they are offered the greatest number of investment opportunities—education, a car, or a washing machine—they also face the tightest budget constraints. Until they gain greater employment experience their income is at its lowest point of their professional lives and can be expected to rise consistently into middle age. They have limited assets and, if they attended college, might have substantial student debt.

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[171] Zywicki, *supra* note 170, at 904-06.

[172] *See* discussion above estimating the rate of return for investments in higher education to be approximately double that of financial investments.

[173] *See* Chapter 3.

[174] Albert Ando and Franco Modigliani, The "Life Cycle" Hypothesis of Savings: Aggregate Implications and Tests, 53 Am. Econ. Rev. 55 (1963).

[175] See S. Katherine Roy, Sparking Better Retirement Conversations and Outcomes, JP Morgan Funds (Jan. 2014).

[176] Jesus Fernandez-Villaverda and Dirk Krueger, *Consumption over the Life Cycle: Facts from Consumer Expenditure Survey Data,* 89 Rev. Econ. & Statistics 552 (2007); *see also* Christopher D. Carroll, Lawrence H. Summers, *Consumption Growth Parallels Income Growth: Some New Evidence, in* National Saving and Economic Performance 305 (1991).

A recent household budget analysis illustrates the lifecycle nature of earning and expenditures. Households under the age of 25 spend 94.6 percent of their income and most younger households have consumer debt.[177] Those between 25-34 years of age spend 70.8 percent of their total income.[178] As households reach middle age (45-54 years old) they spend on 64.6 percent of their income.[179] By the time a household reaches 75 years of age, spending rises again to 95.6 percent of income, even though average total spending falls from $64,781 per year to $40,211 annually.

But there is not only a tradeoff between current consumption and saving for the future. There is also a tradeoff between saving for long-term goals, such as retirement, and short and medium-term goals, such as emergency savings or to purchase a home or pay for children's college. Thus, households dramatically increase their retirement savings when their children leave home[180] and after making their final mortgage payment.[181] Consumers may also offset increased savings in the short-run by reducing future savings. Because of this offsetting behavior, researchers have found that policies that auto-enroll consumers in a company's retirement plan may increase retirement savings amounts in the short run but have a "negligible" effect on long term household wealth.[182]

Should Consumers Save More and Work More?

Instead of reducing consumption or short-term savings today in order to shift income to the more distant future, consumers instead could theoretically increase their permanent income by increasing their income today, thereby enabling them to save more without reducing current consumption.[183] To increase income, however, requires working more hours—i.e., increasing labor and reducing leisure.

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177 Jeff Desjardins, *How Americans make and Spend Their Money by Age Group* (Aug. 26, 2019), *available in* https://www.visualcapitalist.com/how-americans-make-and-spend-their-money-by-age-group/ (Total average income of $32,893 and spending of $31,102).

178 *Id.* People in this age bracket have average total income of $69,062, spend $48,928, and save $12,218.

179 *Id.* These households save almost 20 percent of their income.

180 Irena Dushi, Alicia H. Munnell, Geoffrey T. Sanzenbacher & Anthony Webb, *Do Households Increase Their Savings When the Kids Leave Home?* (Ctr. for Ret. Res. at Bos. Coll., Working Paper No. 2015–26, 2015).

181 Brahima Coulibaly & Geng Li, Do Homeowners Increase Consumption After the Last Mortgage Payment? An Alternative Test of the Permanent Income Hypothesis, 88(1) Rev. Econ. & Statistics 10 (2006).

182 *See* Taha Choukhmane, *Default Options and Retirement Saving Dynamics*, working paper (Jan. 2, 2019).

183 *See* Zywicki, *supra* note 170, at 908-10.

But time, like money, is a scarce resource, and the opportunity cost of more income is less free time to spend with family, exercise, sleep, or other personally rewarding activities.[184] Seventy-five percent of Americans "don't get enough sleep" relative to recommended levels.[185] Five percent of the working population already works two jobs.[186] Ninety-five percent of workers wish that they could spend more time with their families[187] and 76 percent of women say they wish they had more time in the day to get things done[188]. Seventy-five percent of single parents who work full time wish that they had more time available to spend with their children.[189] Many people also would like to engage in volunteer activities more often but blame a lack of time for their inability to do so.[190] The most frequently expressed reason for why people do not exercise more is lack of time.[191]

It is unlikely that a full-time employee will be made better-off overall by working additional hours or a second job in order to boost long-term savings. Assuming that they are currently employed in their highest-valued employment opportunity and allocating work hours effectively, additional hours of work will presumably provide diminishing marginal returns. At the same time, the opportunity cost of spending additional time at work in terms of foregone free time or leisure shows increasing marginal value with each hour foregone. Retirees, by contrast, have the opposite tradeoff—they have ample free time and minimal work obligations. Thus, instead working more to save greater amounts for retirement, for many people it makes more sense to extend their working career and retire later or work part-time in retirement. This approach of continuing to work longer at the end of one's career can be financially sensible as well. According to one analysis, "The basic result is that delaying retirement by 3-6 months has the

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184 *Id.* at 908.

185 *National Survey Shows 75 Percent of Americans Don't Get Enough Sleep,* Business Wire (May 1, 2015), http://www.businesswire.com/news/home/20150501005855/en/National-Survey-Shows-75-Percent-Americans-Don%E2%80%99t.

186 U.S. Census Bureau, Profile America: Facts for Features (July 7, 2010), https://www.census.gov/newsroom/releases/archives/facts_for_features_special_editions/cb10-ff15.html.

187 *See* Kerby Anderson, Making the Most of Your Money in Tough Times 25 (2009).

188 *Id.*

189 *See* Allison Sidle Fuligni & Jeanne Brooks-Gunn, *Meeting the Challenges of New Parenthood: Responsibilities, Advice, and Perceptions, in* Child Rearing in America: Challenges Facing Parents with Young Children 83, 96 (Neal Halfon, Kathryn Taaffe McLearn & Mark A. Schuster eds., 2002).

190 *See* Marc A. Musick & John Wilson, Volunteers: A Social Profile 148–49 (2008).

191 Chrisanna Northrup, *"Not Enough Time To Exercise" Is Just an Excuse,* Huffington Post (Oct. 15, 2011), http://www.huffingtonpost.com/chrisanna-northrup/exercise-excuse-internet_b_927097.html.

same impact on the retirement standard of living as saving an additional one-percentage point of labor earnings for 30 years."[192]

Borrowing More to Save More

A final option for budget-constrained consumers would be to increase savings while at the same time increasing borrowing to maintain current levels of consumption. For example, a young person could save for retirement while simultaneously borrowing on credit cards or using high-cost credit to purchase consumer durables, financing a motor vehicle purchase, or paying for the expense of raising children, such as orthodontia, school expenses, athletics, and other costs.

Although this approach seems to make little economic sense, efforts to try to promote higher savings rates can produce this behavior. For example, when employees are automatically-enrolled in a company's retirement plan they can end up with greater levels of retirement assets but also simultaneously higher consumer debt levels.[193] Beshears, et al., studied the financial behavior of a group of newly-enlisted army soldiers who were automatically enrolled in the federal government's Thrift Savings Plan ("TSP") at a default contribution rate of 3 percent of their salary. Using a standard model specification, they found that increased levels of retirement savings was correlated with higher levels of auto and mortgage debt several years later.[194] But these findings also could also underestimate debt usage by their subject cohort, members of the military, by excluding debt that does not appear on a consumer's credit report, such as payday and other small-dollar loans, which are heavily used by military members.[195] Notwithstanding the prohibitions of the Military Lending Act, which seeks to limit high-cost loans to active-duty military members, use of alternative financial products is estimated six to eight times higher among military families than among the general public, which suggests that excluding those

[192] Gila Bronshtein, Jason Scott, John B. Shoven, and Sita N. Slavov, *The Power of Working Longer*, 18 J. of Pension Econ. and Fin. 623 (2019).

[193] *See* John Beshears, James J. Choi, David Laibson, Brigitte C. Madrian, and William L. Skimmyhorn, *Borrowing to Save? The Impact of Automatic Enrollment on Debt*, National Bureau of Economic Research, NBER Working Paper 25876, *available in* http://www.nber.org/papers/w25876 (May 2019).

[194] An alternative regression specification that stipulated an interaction between employee tenure and demographics did not find such an effect. The authors provided no theory or explanation for why they would expect there to be an interaction effect between those two variables, however. *Id.*

[195] As with 401(k) plan loans in the private sector, borrowing against a TSP plan is not reported to credit reporting agencies.

types of consumer debt might underestimate the offsetting effect of higher consumer debt loads from increased retirement savings rates.[196]

Another study found that when consumers earmark funds to save for a particular purpose they are slow to reallocate those funds to meet other anticipated expenses. As a result, when confronted by an unexpected expense or emergency, they maintain savings in low-interest savings accounts while simultaneously carrying higher interest-rate consumer debt.[197] One possible explanation for this behavior is that many consumers have been socially conditioned that savings is "sacred" and should not be touched except for the intended purpose; therefore they associate their saving with their "own sense of self and personal responsibility." Thus, ironically, although the purpose of promoting savings is "to reduce reliance on costly consumer credit," the end result might be the opposite.[198]

Government policy penalizes early withdrawal of funds earmarked for retirement, even for emergency purposes known as "hardship withdrawals." The imposition of a penalty for early withdrawal is rationalized as a device for forcing people to "pre-commit" to creating a pool of retirement savings that is difficult for them to access for impulsive or irrational expenditures. Yet people face bounded rationality and uncertainty about the future, thus their beliefs about future household financial circumstances can be upended by a variety of life events, from an unexpected child to an unexpected need for a new roof. According to a survey of American workers by Transamerica in 2015, the reasons for which people take hardship withdrawals do not appear to be irrational: 28 percent did so to pay for medical expenses, 17 percent to avoid eviction or foreclosure on their home, 14 percent to pay for college tuition and related fees, 12

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[196] According to a 2018 analysis by Javelin Strategy & Research, 44 percent of active military members used a payday loan in the last year, 68 percent used a tax refund loan, 53 percent used a non-bank check casher, and 57 percent used a pawn shop. *See* Al Pascual, *How Can Military Personnel Escape the Clutches of the Pay Day Loan Trap*, Javelin Strategy & Research (July 5, 2018), *available in* https://www.javelinstrategy.com/blog/clone-are-auto-loans-next-amazon. Usage for each of these categories of alternative financial products is about six to eight times higher than the general population. Members of the military might also make heavier use of bank overdraft protection than the general public, *see* Todd Zywicki, *Payday Lending and Overdraft Protection*, The Volokh Conspiracy (Jan. 17, 2014), *available in* http://volokh.com/2014/01/17/payday-lending-overdraft-protection/, as well as bank deposit advance products, *see* Consumer Financial Protection Bureau, The Extension of High-Cost Credit to Servicemembers and Their Families (Dec. 2014), *available in* https://files.consumerfinance.gov/f/201412_cfpb_the-extension-of-high-cost-credit-to-servicemembers-and-their-families.pdf, which also are not reported to credit reporting agencies and thus would not appear in their data. Any loans taken against their retirement plans also would not appear on their credit record.

[197] See Abigail B. Sussman & Rourke L. O'Brien, Knowing When to Spend: Unintended Financial Consequences of Earmarking to Encourage Savings, 53 J. Marketing Research 790 (2016).

[198] Id.

percent to repair damage to their home, 7 percent to pay for burial expenses for a member of the family, and 7 percent to purchase a home.[199]

Instead of withdrawing funds early from a retirement plan, workers can borrow against their retirement savings to meet unexpected emergencies. According to TIAA-CREF, the top five reasons why people borrow against their 401(k) plan, an act that is analogous to an early withdrawal, are the following: 46 percent said they borrowed to pay off debt, 35 percent to pay for an emergency expenditure, 26 percent for a home purchase or renovation, 24 percent to pay bills due to a job loss, and 20 percent for education costs for themselves or their children.[200] Borrowing against one's 401(k) plan is less expensive than paying penalties for early withdrawal and usually entails paying a modest up-front fee but not major expenses; otherwise, although unlike other types of consumer credit those loans are not dischargeable in bankruptcy.[201] Still, many liquidity-constrained consumers end up using and carrying higher-cost consumer debt before turning to 401(k) loans. Li and Smith found that this results in a net loss of approximately $1-$2 billion annually to those households[202]

Consistent with the prediction that budget-constrained consumers might offset higher retirement savings by taking on higher levels of debt, liquidity-constrained households—younger, lower-income, and lower wealth outside their retirement accounts—are the group most likely to borrow from their 401(k) plans.[203] One study found that 20 percent of workers borrow against their 401(k) plans at any given time and 40 percent borrow at some point over five years.[204] Moreover, 86 percent of workers who change jobs (usually because they were fired)

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[199] Transamerica Center for Retirement Savings, 16th Annual Transamerica Retirement Survey: A Compendium of Findings About American Workers 38 (Aug. 2015), https://www.transamericacenter.org/docs/default-source/resources/center-research/16th-annual/tcrs2015_sr_16th_compendium_of_workers.pdf. According to Transamerica, about 6% of American workers took an early withdrawal from their 401(k) plan in 2015.

[200] TIAA-CREF, *Should You Borrow Against Your Retirement Plan?*, https://www.tiaa-cref.org/public/advice-guidance/saving-for-retirement/borrow-from-retirement-plan.

[201] Interest payments are made to oneself.

[202] *See* Geng Li and Paul A. Smith, *401(k) Loans and Household Balance Sheets*, 63 National Tax J. 479 (2010). The authors suggest that one explanation for why more consumers do not use 401(k) loans instead of consumer credit might be because of the risk associated with default, namely the inability to discharge those obligations in bankruptcy. It also seems possible that as suggested by Sussman, et al., consumers may have been socially conditioned to believe that they are not "supposed" to access retirement savings early and that these funds are "sacred" and to be used only for their originally intended purpose, notwithstanding unexpected changes in the household's financial condition.

[203] *See* Timothy (Jun) Lu, Olivia S. Mitchell, Stephen P. Utkus, and Jean A. Young, *Borrowing from the Future? 401(k) Plan Loans and Loan Defaults*, 70 National Tax J. 77 (2017).

[204] *See* Lu, et al., *supra* note 203; *see also* Li and Smith, *supra* note 202, at 504 ("We find that households that do hold 401(k) loans have more debt, fewer non-401(k) assets, and higher incidence of liquidity and borrowing constraints than households without 401(k) loans, suggesting that households tend to use 401(k) loans as borrowing of last, rather than first, resort.").

after taking a loan end up defaulting, resulting in $5 billion annually in losses plus $1 billion per year in tax obligations for those who default.[205] Those who defaulted on their loans after leaving their jobs were generally younger, had shorter job tenure, lower income, lower balances, and less non-retirement wealth than those who repaid their loans after leaving.[206]

Inducing people to save more money for the future does not eliminate their budget constraint or the need to make tradeoffs among competing financial priorities at any given time or intertemporally. As a result, the Taskforce urges policymakers to act with caution before implementing policies designed to "nudge" or otherwise displace household's retirement or other savings patterns until all of their intended and unintended consequences of such policies are fully understood.[207] Of particular concern is the possibility that those nudged or pushed into retirement plans will offset this forced diversion of income into the future by increasing borrowing today, resulting in simultaneous holding of high-interest consumer debt with lower-yielding retirement plan assets.

12.3.2 Are Americans Saving Enough for Retirement?

Conventional wisdom holds that there is a retirement savings "crisis" in the United States.[208] Available evidence, however, suggests that this concern is overstated with respect to both current and future retirees.

Current retirees appear to be in excellent financial health. The poverty rate for Americans over the age of 65 is lower than for working-aged households.[209] Average net worth of older household is higher than for any other age group.[210] In addition, between 2000 and 2011, income among 70 year olds increased across all income brackets with income increasing faster

[205] Lu, et al., *supra* note 203.

[206] Lu, et al., *supra* note 203.

[207] The Taskforce supports experiments by employers with respect to different approaches to employee benefits, including retirement plans, that will help to discover their employees' preferences but urge caution about imposing government mandates or preferences that could interfere with this discovery process. *See* Adam C. Smith and Todd J. Zywicki, *Nudging in an Evolving Marketplace: How Markets Improve Their Own Choice Architecture, in* Nudge Theory in Action: Behavioral Design in Policy and Markets 225 (Sherzod Abdukadirov, ed., 2016).

[208] *See* Ilana Boivie and Nari Rhee, The Continuing Retirement Savings Crisis (National Institute for Retirement Security, Mar. 2015)

[209] *See* Jessica Semega, Melissa Kollar, John Creamer, and Abinash Mohanty, Income and Poverty in the United States: 2018 at 15, Fig. 10 (June 2020).

[210] *See* Neil Bhutta, Jesse Bricker, Andrew C. Chang, Lisa J. Dettling, Sarena Goodman, Joanne W. Hsu, Keven B. Moore, Sarah Reber, Alice Henrqiques Volv, and Richard A. Windle, *Changes in U.S. Family Finances From 2016 to 2019: Evidence from the Survey of Consumer Finances*, 106(5) Fed. Res. Bulletin 1, at 11 Table 2 (Sept. 2020).

among the lowest income brackets.[211] Other researchers have also found high levels of income and financial security among older Americans and low levels of poverty.[212] From 1989 to 2016 the median retiree household's income grew by 56 percent above inflation compared to only 4 percent real growth for working-age households.[213] Overall, only 4 percent of retirees in 2018 said that they were "finding it difficult to get by."[214]

Moreover, income security has increased for lower-income households as well. According to economist Andrew Biggs, from 1989 to 2016, real income grew faster among the poorest 5th percentile of retirees than at the 95th percentile of the working-age population.[215] Among those with a high school education or less, only 7.25 percent of those aged 62 to 67 reported that they were "finding it hard to get by" compare to 12.5 percent of those aged 57 to 61.[216] The relative financial well-being of lower-income households in retirement stems from the progressive nature of Social Security benefits, under which the replacement rate of pre-retirement earners for lower-income workers is two to three times higher on average than replacement rates for higher-income workers.[217] Low-earning workers receive benefits from social security equal to about 84 percent of his career-average earnings, adjusted for inflation, while higher-earning workers receive only 43 percent.[218] Because low-income workers tend to have lower expenses and high replacement rates from government benefit programs, they suffer little reduction in their overall income when they retire, notwithstanding often holding limited private savings.[219] In part, however, lower level of private retirement savings among lower-income households

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[211] *See* John Beshears, James Choi, David Laibson, and Shanthi Ramnath, *Trends in Retirement Income Adequacy*, NBER Working Paper 19-06 (Aug. 2019).

[212] *See* Adam Bee and Joshua Mitchell, *Do Older Americans Have More Income Than We Think?*, Census Bureau Working Paper No. SEHSH-WP2017-39 (July 25, 2017), *available in* https://www.census.gov/library/working-papers/2017/demo/SEHSD-WP2017-39.html.

[213] *See* Andrew Biggs, *The Phony Retirement Crisis*, Wall St. J. (Feb. 28, 2019), *available in* https://www.wsj.com/articles/the-phony-retirement-crisis-11551398196 (citing Federal Reserve data).

[214] *See* Andrew Biggs, *Rising Retiree Bankruptcies? It's a Myth*, Washington Examiner (Sept. 6, 2019) (citing Federal Reserve data).

[215] *Id.*

[216] *See* Andrew G. Biggs, *Stop Pushing Poor People to Save More for Retirement*, Marketwatch.com (Sept. 12, 2019), *available in* https://www.wsj.com/articles/the-phony-retirement-crisis-11551398196.

[217] *See* Congressional Budget Office, Social Security Replacement Rates and Other Benefit Measures: An In-Depth Analysis (Apr. 16, 2019), *available in* https://www.cbo.gov/publication/55038.

[218] Biggs, *Stop Pushing*, *supra* note 216.

[219] *Id.* (Recent research by economists at the Internal Revenue Serve and the Investment Company Institute found that the median low-income retiree has a retirement income equal to 103% of earnings just prior to retirement. Other research from Census Bureau economists found similar results: retirees at the 25th percentile of the income distribution had incomes equal to 93% of their average earnings in the 15 years prior to retirement." (citations omitted)).

reflects counterproductive and perverse incentives within government means-tested social welfare programs that penalize those who build liquid and retirement savings through punitive reductions in means-tested government benefits.[220]

Indirect evidence of the robust household financial health is the finding from the 2019 *Survey of Consumer Finances* that 50 percent of individuals from families whose parents had a college degree have already received an inheritance bequest, trust, or gift and over 30 percent of those from families whose parents did not receive a college degree also have received or plan to receive an inheritance.[221] Those whose parents had college degrees have received or expect to receive averages gifts ranging from $92,00-$200,000 and those from families with non-degree parents have received or expect to receive gifts ranging from $76,000-$100,00.[222]

Overall, there is no obvious crisis among already-retired Americans. Poverty rates are low and income and net wealth levels are high. But what about future retirees?

There is substantial methodological debate over how to measure future retirement security.[223] Overall, properly understood, the evidence indicates that a clear majority of Americans are saving enough or more than enough for future retirement. According to one prominent study by Gale, Scholz and Seshadri, as of 2004 approximately three-quarters of households had accumulated sufficient wealth to maintain pre-retirement living standards in retirement.[224] This estimate is similar to that in a more recent study by Hurd and Rohwedder, who found that about 71 percent of households are able to maintain their path of consumption in retirement with financial insecurity concentrated among single, low-educated women.[225] Other studies, by contrast, found expected shortfalls in retirement savings to be more equally distributed among the population. Moreover, the magnitude of shortfalls varies by income group—the shortfall is smaller among lower-income households because of their lower baseline household budget and Social Security's higher replacement rates from government benefits whereas the shortfall might be larger in magnitude for higher-income households. Those who save less for retirement also

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[220] *See* Biggs, *Stop Pushing, supra* note 216.

[221] *See* Bhutta, *supra* note 210, at 14-15, Box 3.

[222] Presumably this expectation of receiving a bequest affects the incentives of the presumed heirs to save from their own income as well.

[223] For a summary of the debate, *see* Andrew G. Biggs, Is there a Retirement Crisis? Examining Retirement Planning in the Household and Government Sectors, Mercatus Research (2017).

[224] *See* William G. Gale, John Karl Scholz, and Ananth Seshadri, *Are All Americans Saving "Optimally" for Retirement?*, Working Paper (Dec. 31, 2009), https://www.ssc.wisc.edu/~scholz/Research/Are_All_Americans_v6.pdf.

[225] *See* Michael D. Hurd and Susann Rohwedder, *Economic Preparation for Retirement, in* Investigations in the Economics of Aging 77 (2012).

on average, unfortunately, have shorter expected lifespans than those who save more, but this also means they typically need to accumulate fewer assets to sustain them through their retirement years.[226]

Many of the models that project shortfalls, however, rest on specific assumptions about the projected work habits of American families, but workers planning for retirement today have revealed different attitudes toward work and retirement than those in the past. Workers are working longer and retiring later than in the past. Workers, on average, are retiring three years later on average than in the 1980s.[227] From 1995 to 2018, the share of people aged 55 to 79 who were employed increased from 33 percent to 44 percent.[228] Further, these additional earning years typically come during a period of their lives where expenses are low as children have left home and housing and other expenses are much lower than during the prime of their child-raising years, enabling wealth accumulation. As mentioned earlier, working three to six months longer at the end of one's career is equivalent to a one percentage point increase in annual retirement savings contributions.[229]

Longer expected work careers are explained by multiple factors. First, eligibility for full Social Security benefits has increased to age 67, leading to longer work careers before retirement. Second, those approaching retirement are typically healthier and many find working more enjoyable than many jobs in the past. Work has also become less physically demanding for many, enabling more workers to extend their expected work careers. Third, as two-working couples have become the norm, older retirees have become more likely to postpone retirement until the age at which the younger spouse can retire as well, leading to increased numbers of people working past their traditional retirement age.

Overall, all of these trends have tended to increase worker's expected work lives leading to extended periods of earnings and delays in the period of drawing down financial assets. In addition, an increasing number of workers express an expectation of working part-time even after they technically retire. Higher-income households have lengthened their working careers more than lower-income households and are more likely to express a plan to continue working

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[226] *See* Zywicki, *supra* note 170, at 911-13 (discussing studies).

[227] *See* Tara Law, *"I Need to Continue to Be Active." Why Americans are Retiring Later Than Ever* (Feb. 6, 2020), *available in* https://time.com/5778992/americans-retiring-later/; *see also* Northwestern Mutual, 2018 Planning and Progress Study: Living Long and Working Longer (2018), *available in* https://news.northwesternmutual.com/planning-and-progress-2018 (noting that a higher percentage of current workers anticipate retiring at 70 years or older than the traditional 65-69 age range).

[228] *See* Congressional Budget Office, Employment of People Ages 55 to 79 (Sept. 26, 2019).

[229] *See supra* note 192 and accompanying text.

longer (and retiring later) than lower-income households.[230] This expectation of working longer, especially among higher-income households, has led them to reduce their savings rates earlier in life and to transfer savings to other purposes, especially saving for their children's college expenses and to purchasing homes.[231] The general transition in the economy from defined benefit to defined contribution plans has also encouraged longer work careers, as delaying retirement enables further contributions and growth in one's retirement portfolio as well as additional income, rather than beginning to draw down accumulated savings at an earlier date. Defined benefit plans, by contrast, provide an incentive to retire as soon as one is eligible for full benefits and not to delay retirement.

Other incentives have also pushed toward longer work careers. Because of the general upward trend in the time spent acquiring schooling, workers are starting their careers later in life but with higher human capital rates that generally depreciate more slowly over time. Staying in school longer also often means higher levels of student debt, which would be predicted to lead workers to plan on working longer as well to accumulate sufficient retirement savings. All of these trends toward longer working lives are generally ignored in models that predict substantial shortfalls in retirement savings in the years to come.[232] The decision when to retire is itself determined in large part by the availability of sufficient resources to live comfortably.[233]

Another factor that generally leads to an overstatement of the rate of financial insecurity in retirement is that most models of retirement savings overestimate the expected amount of resources needed for retirement because they overestimate the amount of funds households need to live comfortably in retirement.[234] Most traditional retirement savings models assume a certain level of income will be necessary for households to maintain their pre-retirement standard of living into retirement, with estimates ranging from 70 percent to 100 percent of pre-retirement income levels and remaining constant through retirement. But, in fact, most projections of retirement spending overstate the amount of income needed to retire comfortably. On average, spending drops about 27 percent between the ages of 55-64 and 65-

[230] *See* Transamerica, *supra* note 199, at 58 (finding that 51% of respondents expect to continue working full-time or part-time in retirement).

[231] *See supra* note 180-181 and accompany text (noting that retirement savings increases after children leave home and the mortgage is paid off).

[232] *See* Zywicki, *supra* note 170, at 891-92.

[233] *Id.*; *see also* Jan Ondrich & Alexander Falevich, *The Great Recession and the Retirement Decisions of Older Workers* (Ctr. for Ret. Res. at Bos. Coll., Working Paper No. 2013-24, 2013) (finding that the decline in home values and retirement assets as a result of the Great Recession reduced the probability of retirement by 15-19 percent).

[234] *See* Zywicki, *supra* note 170, at 886-890.

75.[235] But then spending drops an *additional* 26 percent after turning 75. Other studies find similar results: for example, one study found that average expenditures fell 19 percent between ages 65 and 75, 34 percent by age 85, and 52 percent by age 95.[236] "Overall, median household expenditures experience an almost constant linear decline from age 50 to 95, falling steadily from approximately $50,000 per year to under $20,000 per year."[237] A 2014 study by Morningstar Investment Management found that because people overestimate the amount of money they will need to retire, they oversave for retirement by about 20 percent, thereby diverting funds toward retirement that could have been used for current consumption or to avoid taking on other debt, such as for their children's college education.[238]

Spending typically declines in retirement for several reasons. First, as people retire, they typically substitute home production of many services (such as cooking, cleaning, lawn care, and home maintenance) for what they might have previously purchased in the market.[239] Second, consumers reduce their replacement rate of consumer durable investments such as appliances, clothing, automobiles, and others. Third, costs associated with working (such as transportation, food, and dry cleaning) fall as well. Finally, as people age they generally become less mobile, leading ultimately to reductions in spending on travel, recreational activities, and the like. As a result of these spending reductions together with asset growth, many households today actually *increase* their wealth levels in retirement rather than drawing down savings.[240]

The shift in the economy from defined benefit pension plans to defined contribution plans has also generally increased financial well-being in retirement for most Americans. The adoption of defined contribution plans has dramatically increased the number of workers who are eligible for tax-preferred retirement plans compared to defined benefit plans. Defined benefit plans frequently offered generous benefits for retirees, but they were very expensive and risky for employers to operate because of the difficulties of predicting long-term payout obligations under

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[235] *See* Ty Bernicke, *Reality Retirement Planning: A New Paradigm for an Old Science*, J. Fin. Planning 56 (June 1, 2005), *available at* http://web.b.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=08afa52b-8a28-420d-90e1-8c2067076338%40sessionmgr110&vid=1&hid=110

[236] Sudipto Banerjee, *Expenditure Patterns of Older Americans 2001–2009*, 2012 Emp. Benefit Res. Inst. 368, at 5.

[237] Zywicki, *supra* note 170, at 889 (citing Banerjee, *supra* note 236).

[238] Gene Chatzky, *You May Be Saving Too Much for Retirement*, Fortune (Jan. 6, 2014), http://fortune.com/2014/01/06/you-may-be-saving-too-much-for-retirement/.

[239] Retirees spend much more time on household tasks such as house cleaning, yard work, shopping, meal preparation and home improvements than when they were working. *See* Michael Hurd & Susann Rohwedder, *The Retirement-Consumption Puzzle: Anticipated and Actual Declines in Spending at Retirement* (Rand, Working Paper No. 242, 2005).

[240] David A. Love, Michael G. Palumbo & Paul A. Smith, *The Trajectory of Wealth in Retirement*, 93 J. Pub. Econ. 1-2, 191 (2009), *available at* http://www.sciencedirect.com/science/article/pii/S0047272708000131.

the plan.[241] Because of their cost, even at their peak, only about 39 percent of employees participated in a defined benefit pension plan.[242] In the mid-1990s, only 35 percent of all private industry workers participated in a defined benefit pension plan with their employer almost all at large businesses.[243] Moreover, defined benefit plans usually had long vesting periods for eligibility. A majority of traditional plans required a minimum of 15 years' service to qualify for full vesting and many also had minimum age requirements as well.[244] Defined benefit plans also restricted labor market mobility, encouraging workers to remain in their current job even if they would prefer to pursue an opportunity.[245]

Defined contribution plans, by contrast, are much less expensive and risky for employers to operate, leading to many more businesses, especially small businesses, offering employer-sponsored retirement plans.[246] Moreover, eligibility and vesting requirements for defined contribution plans are shorter than for defined benefit plans, making them fairer and more accessible for workers who move in and out of the workforce or change jobs more often, such as working parents and younger workers. Whereas the average vesting period for a defined benefit plan was five years, 60 percent of defined contribution plans provide for immediate vesting and 85 percent provide for vesting within one year or less.[247] Defined contribution plans also protect employees from the risks of employer insolvency, as employees have property rights in their amounts contributed, even if the firm goes bankrupt. Shorter vesting periods increase labor mobility and efficiency and relieve workers of the burden of staying at their current job and foregoing a better employment opportunity elsewhere. Minority and less-educated workers

[241] They also raised a non-trivial risk of employer underfunding which could leave promised beneficiaries empty-handed if the firm went bankrupt. In fact, the enactment of ERISA, which imposed new regulations on employers to guarantee adequate funding of retirement plans, instead had the unintended consequence of leading employers to abandon them all together. *See* Richard A. Ippolito, *A Study of the Regulatory Effect of the Employee Retirement Income Security Act*, 31 J. L. & Econ. 85 (1988); Richard A. Ippolito, *Bankruptcy and Workers: Risks, Compensation and Pension Contracts*, 82 Wash. U. L. Q. 1251 (2004).

[242] *See* Biggs, *Phony, supra* note 213.

[243] *See* William J. Wiatrowski, *The Last Private Industry Pension Plans: A Visual Essay*, Monthly Labor Rev. 4 (Dec. 2012).

[244] John W. Thompson, *Defined Benefit Plans at the Dawn of ERISA*, U.S. Bureau of Labor Statistics (Mar. 30, 2005), *available in* https://www.bls.gov/opub/mlr/cwc/defined-benefit-plans-at-the-dawn-of-erisa.pdf.

[245] For example, public employee defined benefit plans have been found to lead to the retention of some low-quality public-school teachers who would prefer to move to alternative employment and the premature exit of some high-quality teachers would otherwise stay. *See* Cory Koedel, Michael Podgursky, and Shishan Shi, *Teacher Pension Systems, the Composition of the Teaching Workforce, and Teacher Quality*, 32 J. of Pol'y Analysis and Management 574 (2013).

[246] See Richard A. Ippolito, Toward Explaining the Growth of Defined Contribution Plans, 34 Industrial Relations 1 (1995).

[247] Vanguard, How America Saves 2015: A Report on Vanguard 2014 Defined Contribution Plan Data 4 (June 2015), *available at* https://pressroom.vanguard.com/content/nonindexed/FactSheet_HAS2015_060915.pdf.

historically have had lower average tenure rates than white and higher-educated workers, thus they were less-likely to develop sufficient tenure to become eligible for a defined benefit plan, which tended to worsen the racial wealth gap in the economy.

Over 60 percent of workers participate in retirement plans today, including about 40 percent of households with below-median income.[248] Eighty percent of *married* couples participate in one of the spouse's retirement plan.[249] According to the Department of Labor, the median job tenure at current employer today is only 4.1 years and the median tenure of younger workers is only 2.8 years.[250] Women, minorities, and less-educated workers, on average, have shorter average job tenures than men, White, and higher-educated workers. Thus, the largest beneficiaries of the transition to defined contribution retirement plans with their earlier vesting provisions have been those with less stable employment, such as women, minorities, and less-educated workers.

In addition, the replacement of defined benefit plans with defined contribution plans has increased the overall resources contributed to employee retirement funds. Defined benefit plans typically were financed only by the employer. Defined contribution plans, by contrast, are primarily financed by employees but employers often offer a "matching" contribution up to a certain percentage.[251] As a result, the total employer and employee contributions to retirement plans increased from 6 percent of employee wages in the 1970s to 8.3 percent today.[252] Many employers also give *non-matching* contributions to employee retirement plans in addition to

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[248] *See* Bhutta, *supra* note 210, at 20, Box 6.

[249] Irena Dushi and Howard M. Iams, *Pension Plan Participation Among Married Couples*, 73 Social Security Bulletin 45 (2013), *available in* https://www.ssa.gov/policy/docs/ssb/v73n3/v73n3p45.html. In 37 percent of cases the husband was the only participate in a retirement plan and in 10 percent of cases the wife was the only participant.

[250] Bureau of Labor Statistics, Employee Tenure in 2020 (Sept. 22, 2020), *available in* https://www.bls.gov/news.release/pdf/tenure.pdf.

[251] According to one estimate, in 2012 95.3% of employers with defined contribution plans made matching contributions, which was a ten-percentage point increase from 2009. Employers increased the average size of their matching contribution to 4.5% of pay, an increase from 3.7% in 2010. *See* Bob Benish, *401(k) Plans ARE Working*, Plan Sponsor Council of Am. (Oct. 17, 2013), http://www.psca.org/401-k-plans-are-working. A survey by the Pew Trusts estimates more than 80 percent of employers offer a plan with matching contributions. *See* Pew, Retirement Plan Access and Participation Across Generations, pewtrusts.com (Feb. 15, 2017), *available in* https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/02/retirement-plan-access-and-participation-across-generations#:~:text=When%20an%20employer%20contributes%2C%20about,the%20employer%20does%20not%20contribute.

[252] *See* Biggs, *Phony Retirement Crisis*, *supra* note 213 (citing Labor Department data).

matching contributions: according to one survey, the average contribution was 5.4 percent of salary and the median value was 3.9 percent.[253]

Overall, analysis by Boston College's Center for Retirement Research concludes that the shift from defined benefit to defined contribution plans has resulted in no net increase in the number of people saving inadequately for retirement:

[I]f returns on accumulations are included, the annual change in pension wealth appears to have remained relatively steady. *In short, the . . . data suggest that people are not accumulating less as the result of the shift from defined benefit to defined contribution plans.*[254]

The general findings of available research thus fail to identify any significant crisis in retirement savings, once changes in patterns of retirement improvements in access to retirement plans, and other changes in the economy are considered. Retirees today are far from destitute—on average, they have the lowest poverty rates of any group in society and higher incomes than at any time on record. Approximately three-quarters of Americans appear to be saving adequately for retirement, even ignoring adjustments for delayed retirement age. Those who appear to be undersaving are either lower-income, in which case government benefits such as social security will replace a large amount of their income, or higher-income, in which case they express an expectation of working past a traditional retirement age. The transition to defined contribution plans has opened access to a much larger section of the workforce, but especially women, minorities, and younger workers who traditionally were unable to qualify for traditional defined benefit pension plans.

12.3.3 Why Don't Some People Save More for Retirement?

The fact that most Americans appear to be saving adequately for retirement, however, raises the question as to why others appear to be falling short of their target for retirement. As noted, in large part this simply reflects a failure to appreciate changing choices about the timing of retirement and the progressive nature of government social welfare benefits, which replace a larger percentage of wage earners' income. Understanding why some people do not save for retirement is necessary as a predicate to determining what government policies, if any, would improve their financial well-being.

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[253] *See* Ashlea Ebeling, *Employers to Chip in More 401(k) Dollars*, Forbes (Apr. 30, 2015), http://www.forbes.com/sites/ashleaebeling/2015/04/30/employers-to-chip-in-more-401k-dollars/#2715e4857a0b4b923c5133ff.

[254] Alicia H. Munnell, Hean-Pierre Aubry, & Caroline V. Crawford, *How Has Shift to Defined Contribution Plans Affected Saving?* 1 (Ctr. for Ret. Res. at Bos. Coll., Working Paper No. 15-16, 2015).

Start with the obvious point: the vast majority of workers who are eligible for an employer-sponsored retirement plan choose to participate, about 80 percent according to several estimates.[255] The rate of uptake among workers increases substantially when employers offer matching contributions.[256] Thus, among those who have access to a retirement plan, the overwhelming number contribute, and as discussed above, the average total contribution level (employer plus employee) is around 8 percent of pay. Of those who do not participate in an employer-sponsored retirement plan, the most common reason is that they are not eligible, had just started working at their new employer, or are employed only part-time.[257] Approximately 33 percent of families have IRA retirement plans.[258]

Leaving aside those who do not have access to a retirement plan or are not eligible, reasons for not participating in retirement savings plans generally boil down to three basic reasons: (1) They simply do not have money left over to save after meeting their current financial obligations, (2) They are paying down consumer debt, (3) they are saving for retirement in other ways or are saving for other priorities, such as a home, college, or some other investment. In other words, consistent with the idea that failure to save is largely a reflection of budget constraints not preferences, those who choose not to save are doing so because they would have to forego current consumption, some other household investment (such as college or a home), or would have to borrow to finance retirement savings. Only a very small number of people suggest that they could actually be saving more for retirement but just haven't gotten around to it or otherwise reflect some lack of appreciation for the long-term value of retirement savings (often referred to as "hyperbolic discounting" or "present bias," or a lack self-control in failing to follow through on a plan to save (inertia or lack of self-control)). This suggests that the primary reason that many people do not save more is because they simply lack enough money to do so in light of other financial priorities, not because they fail to appreciate the value of saving for retirement or irrationally fail to follow through on their plans.

The most common reason why eligible workers state that they do not participate in their employer-sponsored retirement plan is that they believe they simply do not have enough money to do so. According to one survey, one-third of those who do not participate in their employer-sponsored retirement plan said they were "financially stretched with other financial

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[255] *See* Transamerica, *supra* note 199, at 31; Craig Copeland, *Individual Retirement Plans: An Analysis of the 2013 Survey of Consumer Finances*, Emp. Benefit Res. Inst. Issue Brief No. 406 at 6 (Nov. 2014) (reporting 78.7% participation rate in defined contribution plans by eligible employees according to the 2013 Survey of Consumer Finances); Pew, *supra* note 251.

[256] Pew, *supra* note 251.

[257] *See* Transamerica, *supra* note 199, at 31.

[258] *See* The Board of Governors of the Federal Reserve System, Report on the Economic Well-Being of U.S. Households in 2019, Featuring Supplemental Data from April 2020 at 47-50 (May 2020).

priorities."[259] In the same survey, 21 percent of non-savers stated the reason they were not saving for retirement was because they were "just getting by" and "covering their basic expenses."[260] In a recent survey, the most common answer to the question "What's the biggest reason you aren't saving more money?" was "Expenses" (named by 38 percent of respondents" and tied for second was "Job isn't good enough" (named by 16 percent).[261] Thirteen percent of respondents listed "debt" as the reason. According to research by the Bureau of Labor Statistics, the strongest predictor of reduced contribution to an employee's defined contribution retirement plan during the Great Recession was reduced labor earnings.[262]

A second reason why many consumers state that they are not saving for retirement is that they are prioritizing paying down consumer debt, such as credit card debt. Twenty percent of respondents in Transamerica's survey stated that their highest financial priority was "paying down consumer debt." Twelve percent stated that paying off their mortgage was their highest financial priority and 4 percent stated that their highest priority was paying off their student debt.[263] Overall, 36 percent of respondents in the survey identified paying off consumer debt of one type or another as their highest financial priority, compared to 27 percent who stated that saving for retirement was their highest priority.

Third, many consumers are saving for other goals, such as building up an emergency reserve fund of liquid savings or for another priority such as to purchase a house or for their children's college education. Some households are choosing to maintain a higher level of liquid savings instead of tying up savings only in long-term illiquid retirement accounts that can be reached solely by paying a penalty or borrowing against the account.[264] In the face of rising economic uncertainty, many workers choose to scale back contributions to their retirement accounts and

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[259] *See* Transamerica, *supra* note 199.

[260] Id.

[261] *See* Amanda Dixon, *Survey 21% of Working Americans Aren't Saving Anything At All*, Bankrate.com (Mar. 14, 2019), *available in* https://www.bankrate.com/banking/savings/financial-security-march-2019/.

[262] *See* Christopher R. Tamborini, Patrick Purcell, and Howard M. Iams, *The Relationship Between Job Characteristics and Retirement Savings in Defined Contribution Plans*, U.S. Bureau of Statistics Monthly Labor Review (May 2013). In a similar vein, according to a survey of retirement plan participation by Pew, workers with children are substantially more likely to cite "affordability" as a reason for not participating in a retirement plan. *See* Pew, *supra* note 251. According to the Transamerica survey, six percent of respondents cited their highest financial priority as supporting or children financially. *See* Transamerica, *supra* note 199, at 22.

[263] *See* Transamerica, *supra* note 199.

[264] *See* discussion *infra* at notes 277-278 and accompanying text.

instead to harvest more resources in more liquid savings accounts, especially lower-income workers with lower job stability.[265]

Others are focused on intermediate-term financial goals, such as buying a house.[266] One survey of 25 to 39 year old consumers found that one-third of participants listed saving for a home down payment as their highest financial priority, followed by debt repayment (25 percent), an emergency fund, and coming in fourth, retirement savings, with travel coming in last. Of the list of five priorities, almost half of respondents listed retirement saving as fourth or fifth in line. Seventy-three percent stated they would hold off on saving for retirement if it meant they could buy a home sooner.

Many parents are focused on saving for their children's' college education instead of retirement saving. According to a survey by T. Rowe Price, 53 percent of parents said saving for college is a higher priority than saving for retirement.[267] Sixty-eight percent said they would be willing to delay their own retirement to pay for their kids' college education. According to Sallie Mae, 14 percent of parents withdrew money from their retirement fund and 35 percent withdrew money from other savings or investments to cover college costs.[268] Seven percent took a loan against their retirement account to help pay for college.[269] Many parents consider paying for their children's college—and helping them to avoid massive debt—to be a higher priority than immediate saving for retirement.

Many of those who do not participate in an employer's retirement plan are either saving for retirement in other ways or saving for other important financial priorities. As noted, although only a little over 60 percent of all workers state that they participate in a retirement plan, 80 percent of married couples participate in a retirement plan.[270] According to Transamerica's

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[265] *See* James Royal, *Survey: Less Than a Third of Americans Have Increased Their Retirement Savings Rate this Year*, Bankrate.com (Aug. 21, 2019), *available in* https://www.bankrate.com/surveys/financial-security-august-2019/.

[266] Alyssa Davies, *Millennials Prioritize Down Payment Funds and Debt Repayment*, Zolo.ca (May 27, 2019), *available in* https://www.zolo.ca/blog/millennials-saving-goals.

[267] *See* Tanza Loudenback, *American Parents Are Putting College Savings Ahead of Retirement—Exactly the Trap Experts Warn Against*, BusinessInsider.com (Aug. 12, 2019), *available in* https://www.businessinsider.com/personal-finance/saving-for-college-parents-top-priority-over-retirement-2019-8.

[268] Sallie Mae, How America Pays for College 2020 at 8 (Apr. 27, 2020), *available in* https://www.salliemae.com/assets/research/HAP/HowAmericaPaysforCollege2020.pdf.

[269] *Id.* at 23, Table 1.

[270] Irena Dushi and Howard M. Iams, *Pension Plan Participation Among Married Couples*, 73 Social Security Bulletin 45 (2013), *available in* https://www.ssa.gov/policy/docs/ssb/v73n3/v73n3p45.html. In 37 percent of cases the husband was the only participate in a retirement plan and in 10 percent of cases the wife was the only participant.

survey, 10 percent of workers state that they are saving for retirement in other ways, such as by owning a business, rental properties, or some other investment property.[271]

By contrast, according to Transamerica's survey, only 6 percent of those who not participating in an employer-provided retirement plan said that it was because they had intended to enroll "but just hadn't taken the time to do it."[272] By contrast, over eighty percent of workers who were not participating in a plan stated that the reason they were not doing so was because they are ineligible, already stretched by current financial obligations, saving for some other purpose (such as to purchase a home or education), saving for retirement in some other way (such as a spouse's plan), or are paying down consumer debt or student loans.[273] None of these constraints on saving more for retirement appear to be irrational, nor are they inconsistent with a stated desire by consumers to save more. They are just unable or unwilling to do so for sensible reasons.

12.3.4 Short-Term Savings

Concern has also been expressed about whether Americans have sufficient short-term savings to meet unexpected financial emergencies or household budget shocks. According to the Bureau's 2020 "Making Ends Meet" Survey, 40 percent of U.S. Consumers reported they had difficult paying a bill or expense the prior year. Medical expenses and job loss or other loss of income were identified as the most-common reasons why consumers had trouble paying bills. Fifty-two percent reported that they could cover their expenses for two months or less if they lost their main source of income using all available sources. Twenty percent could cover expenses for only two weeks or less.

In its *Report on the Economic Well-Being of American Households*, the Federal Reserve explored some of the challenges associated with economic stability and meeting short-term financial challenges. The survey reported that 63 percent of Americans would cover a $400 emergency expense completely using cash or its equivalent (defined as using a credit card paid off at the next statement).[274] The percentage of people saying they had this potential increased steadily from 50 percent in 2013 to 63 percent in 2019. During that same time period, the

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[271] Transamerica, *supra* note 199.

[272] *See* Transamerica, *supra* note 199.

[273] Id.

[274] *See* The Board of Governors of the Federal Reserve System, Report on the Economic Well-Being of U.S. Households in 2019, Featuring Supplemental Data from April 2020 at 21-25 (May 2020).

percentage of families that reported saving out of current income also rose across all income groups.[275]

Of those who responded that they would not cover the emergency expense with cash or its equivalent, the most common way they would cover the expense was by using a credit card and pay it off over time (15 percent).[276] Only twelve percent of respondents stated that they would be unable to pay for the expense in any way and only two percent stated that they would use a payday loan, deposit advance, or bank overdraft to cover the expense.

But that 37 percent of respondents said that they "*would* not" use cash to pay the expense does not mean that they *could* not do so. Some households who could pay off the expense by cash choose not to do so, apparently in order to maintain precautionary liquid savings. In 2016, for example, 84 percent of families reported holding at least $400 in liquid accounts including transaction accounts (including checking and savings accounts), cash, prepaid cards, and directly held stocks, bonds, and mutual funds.[277] Approximately 20 percent of those who unable to cover three months of expenses out of their liquid savings actually have sufficient assets in "quasi-liquid" accounts such as retirement plans, certificates of deposit or savings bonds, or cash-value life insurance accounts.[278] Altogether, this suggests that the number of consumers in dire circumstances and would be unable to come up with $400 in cash is smaller than would seem to be the case at first glance. This suggests that some consumers hold sufficient assets to cover unexpected emergencies out of liquid funds, but choose to hold funds in higher-yielding, less-liquid accounts and to meet unexpected expenses by borrowing, rather than holding more liquid funds that generate limited yield.[279]

Unsurprisingly, lower-income households are much less likely to have $400 in liquid savings than higher-income households. In addition, households with children are least likely to have emergency savings at hand, and single parent households are especially likely to lack emergency savings.[280] This is consistent with a frequently-stressed point throughout this report—family

[275] Bhutta, *supra* note 210, at 13, Box 2.

[276] *See* Board of Governors, *supra* note 274, at 21-25 (May 2020).

[277] *See* Neil Bhutta and Lisa Dettling, *Money in the Bank? Assessing Families' Liquid Savings Using the Survey of Consumer Finances*, FEDS Notes (Nov. 19, 2018), *available in* https://www.federalreserve.gov/econres/notes/feds-notes/assessing-families-liquid-savings-using-the-survey-of-consumer-finances-20181119.htm.

[278] Bhutta and Dettling, *supra* note 277.

[279] *Id.* This could also be consistent with the observation above that once consumers earmark savings for a particular purpose, such as retirement, they might have difficulty psychologically using those funds for an alternative purpose, leading them to instead use higher-cost consumer debt instead.

[280] Id.

formation and child-raising is a very expensive proposition that puts great financial stress on a household. Credit use, in general, is highest during the early age of family formation and, as these data indicate, is especially stressful for single parent households.

Thus, the grim reality is that those who are unable to come up with $400 in an emergency are most likely unable to do so simply because they are already financially pressed merely to cover their current ongoing expenses. For example, those who are less confident in their ability to access credit in the future were more likely to use their current credit and to retain some savings.[281] Forty-three percent of those who said they would have to borrow or sell something stated that they were financially struggling and 71 percent of those who reported they could not pay the bill were struggling to get by or just getting by financially.[282] Moreover, minority and less-educated households are more likely that White and more-educated households to report that they are not able to fully pay their current month's bills.[283]

In short, it appears that those who are not saving for emergencies are not doing so because they do not appreciate the value of saving or are spending recklessly. Most of them simply do not have excess income they can save and some have savings that are not liquid. Many of those who say they would not cover the shortfall out of savings said they would use a credit card.[284] Solutions to these problems of insufficient income largely lie outside the consumer financial system.

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[281] Olga Gorbachev and Maria Jose Luengo-Prado, *The Credit Card Debt Puzzle: The Role of Preferences, Credit Access Risk, and Financial Literacy*, 101 Rev. of Econ. and Statistics 294 (May 2019).

[282] *See* Board of Governors, *supra* note 274, at 23, Box 3.

[283] *See* Board of Governors, *supra* note 274, at 24, Fig. 16.

[284] One unexamined reason for why some households cannot meet an emergency expense or could do so only by selling something could be that they are unbanked and lack a safe and convenient location to save money.

CHAPTER 12, APPENDIX A:

The NCCF Report: Summary of Recommendations Regarding Financial Education

Chapter 11 of the NCCF report discussed financial education programs in schools and programs available to adults. The discussion provided assessments and recommendations for school programs, adult education, and remedial education.

School Programs

The NCCF noted a general agreement among educators that students should receive some financial education before they left school. However, educators differed widely in their views about the details of such education—when and where should it start, what emphasis should it have, whether it should be mandatory, and what should be taught. A diversity of school programs reflected these differences.

The NCCF expressed several opinions about these issues. On the curriculum, the NCCF suggested that financial education might deliver better results if spread across various courses—economics, business, mathematics, and social science, for example—rather than a special dedicated course. The NCCF reasoned that one or another of these courses is taken by a large percentage of students. Many more students could be reached through these courses than through a single course that may appear to have little immediate value to many students. The NCCF cautioned that this approach requires some coordination among courses to provide students adequate training but avoid unnecessary duplication.

On teachers and textbooks, the NCCF recommended that the consumer credit content include teaching the importance of establishing a good credit history, setting goals and values that suit individual needs, prudent use of credit, and budgeting credit payments within income constraints. The NCCF advised teachers against teaching their own personal values regarding consumer credit. Different situations may warrant different goals. Instruction and materials aimed at middle and high-income students may not be useful or effective for lower income consumers, for example.

Finally, the NCCF recommended increased government and also private funding to develop better curricula to prepare students for participation in the market, with adequate attention to consumer credit as one aspect of family budgeting. Financially literate consumers, the commission argued, would be better equipped to make informed decisions about using credit, choosing credit terms, and selecting lenders.

Adult Education

State and federal agencies should continue their support for adult education for low-income consumers. The NCCF also recommended that governments develop adult education programs for older consumers. Furthermore, federal resources should be used to support research to improve adult education.

Remedial Education

In addition, the NCCF recommended that businesses should support and encourage nonprofit credit counseling that benefits consumers and does not serve primarily as collection agencies. Private debt adjusting services should be regulated and supervised.

The NCCF also recommended that counseling should generally be required for obtaining a discharge for Chapter 13 and 7 bankruptcy. The NCCF also suggested case-by-case exemption when counseling would be unnecessary or futile.

13. The regulatory framework of federal consumer financial protection law and opportunities for modernization

Federal consumer financial law is a labyrinthian system Daedalus might admire. It is a patchwork quilt of interwoven laws and regulations that sprung up as piecemeal, uncoordinated responses to financial crises. It is administered by a constellation of executive and independent agencies with varying institutional structures, some with overlapping jurisdiction and purpose. Despite its chaotic look and feel, the true marvel is that this convoluted system of "regulatory jumble"[1] largely works.

In the decade since the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted, the fissures in the financial regulatory regime have revealed faults and inefficiencies in the system. The world has changed. Greater access to technology and information and an emphasis on convenience have upended the way consumers and financial institutions interact. The Consumer Financial Protection Bureau (CFPB or Bureau) has reshaped the way financial firms work with the government and consumers alike. Most recently, the COVID-19 global pandemic has spotlighted the financial system's clunky design and immobility in the face of changing circumstances.

As the facts of today clash with the past, it is important that the financial regulatory framework adapt. Congress, regulators, and policymakers must continually consider ways to improve, modernize, and update the laws. The goal should not be to reach an unattainable state of

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[1] Elizabeth Warren, *Unsafe at Any Rate: If it's good enough for microwaves, it's good enough for mortgages. Why we need a Financial Product Safety Commission* (2007), available at https://democracyjournal.org/magazine/5/unsafe-at-any-rate/.

regulatory nirvana but to build a better, more nimble system that works for more people – especially those who are most vulnerable.

This Chapter will explore the contours of the regulatory framework underpinning consumer financial law with an analysis of the role of the Bureau, other federal agencies, and states. This Chapter will also analyze the successes and failures of the current regulatory system and opportunities for improvement.

13.1 The Federal Financial Regulatory System Overview of the CFPB and Its Jurisdiction

The CFPB is one of many financial services industry watchdogs. Congress endowed the agency with expansive authority and jurisdiction to take on the task of coordinating and concentrating consumer financial protection powers previously held by seven other agencies.

As discussed in Chapter 6, the concept of a consumer protection agency appears in the 1972 Report of the National Commission on Consumer Finance (NCCF), which calls for a new consumer protection "Federal Watchdog Agency" with a specific bureau dedicated to financial services. According to the NCCF Report:

> The Commission's review of supervision and examination of credit grantors by state and Federal agencies charged with those responsibilities has uncovered certain weaknesses in the enforcement of state and Federal consumer credit protection laws. To strengthen protection of the consumer in the credit market the Commission feels that an organizational unit is needed at the Federal level to coordinate activities of supervisory agencies, improve compliance with existing Federal and state consumer credit protection laws, implement certain of the Commission's recommendations and continue certain of the basic consumer credit market research initialed by the Commission. Therefore *the Commission recommends that Congress create within the proposed Consumer Protection Agency a unit to be known as the Bureau of Consumer Credit (BCC) with full statutory authority to issue rules and regulations and supervise all examination and enforcement functions under the Consumer Credit Protection Act, including TIL.* [2]

[2] NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 58 (Dec. 1972) (italics in original).

The NCCF also called for substantial revisions to the regulatory and enforcement policies of various federal and state regulatory and enforcement agencies. As the Commission wrote, "[i]n this connection the Commission notes that state as well as Federal enforcement of laws dealing with consumer credit has been uneven at best, and that definite improvement is called for. Passage of laws ultimately left in desuetude is no help to borrowers or creditors."[3] According to the NCCF, federal banking regulators "charged with supervising deposit-holding institutions," on the other hand, "have evidenced great interest in the solvency of the institutions, much less interest in enforcing Federal consumer credit laws, and virtually no interest in enforcing state consumer credit laws."[4] The Commission stressed the essential role played by the states in enforcement, arguing enforcement was "too broad to assign other than to the states, perhaps with Federal monitoring."[5] But, the Commission added, "Consumers are entitled to much better consumer credit protection law enforcement at the state level than they have been receiving."[6] Despite the NCCF's call for a federal consumer protection watchdog agency to address these deficits, the idea laid dormant for decades as the Federal Trade Commission (FTC), states, and prudential regulators stepped in to assume overlapping authority for various elements of the consumer financial protection system.

Scholars generally credit the Bureau's beginning to Senator Elizabeth Warren. In 2007, then-professor Warren advocated for added consumer protection in the financial services industry. Up to that point, regulation, examination, and supervision were primarily concerned with ensuring the safety and soundness of financial institutions with consumer protection as an ancillary concern.[7] Further complicating matters, these regulatory functions were distributed among several federal and state agencies with disparate agendas and ideologies. No one agency devoted its time and resources to the specific task of promoting the needs of the average consumer or protecting them in the financial marketplace.

Professor Warren noted that consumers financial health could significantly impact their overall well-being. In recognition of this fact, she envisioned a protection agency modeled after the Consumer Product Safety Commission (CPSC) that would set minimum safety standards and improve consumer confidence in the financial marketplace. Shortly after Professor Warren's

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[3] *Id.* at 4.

[4] *Id.* at 57.

[5] *Id.*

[6] *Id.* at 61.

[7] Some have argued that safety and soundness assessments are primarily focused on ensuring an institution's profitability rather than the prevention of consumer harm. *See* Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction*, 32 Rev. Banking & Fin. L. 321, 330–31 (2013). However, federal regulators did undertake examinations to assess compliance with consumer protection laws.

proposal was published, the subprime mortgage market collapsed. And her ideas paved the way for augmented consumer rights and checks in the financial services industry through the creation of the Bureau.

13.1.1 Bureau Organizational Structure

In 2010, Congress passed the Dodd-Frank Act, which included the Consumer Financial Protection Act (CFPA). The CFPA established the Bureau as an independent, executive agency within the Federal Reserve System.[8] Accordingly, the Federal Reserve System funds the Bureau. Each year or quarterly, the Director determines an amount reasonably necessary, subject to a statutory cap, to carry out the functions of the agency, which the Board of Governors of the Federal Reserve System (FRB) subsequently releases.[9]

Importantly, neither the Bureau's request for funding nor the Bureau's activities, in general, are subject to the FRB's approval.[10] Congress's appropriations committees also lack the authority to review the Bureau's request for funds.[11] The CFPA requires the Director to provide the Office of Management and Budget (OMB) with a copy of its financial operating plans and forecasts, but the OMB lacks approval authority over the funding as well.[12] And although the Comptroller General conducts annual financial audits of the Bureau, which are ultimately provided to the President and Congress, the CFPA does not provide the Comptroller General, the President, or Congress with explicit authority to intervene should an audit suggest the Bureau's budget is unreasonable.[13] In this way, the Bureau maintains a level of independence from the FRB, other members of the executive branch, the President, and Congress.

The purpose of the Bureau is to consistently implement and enforce federal consumer financial law to ensure that all consumers have access to financial services markets and that those markets are fair, transparent, and competitive.[14] To summarize the provisions of the CFPA, the primary functions of the Bureau are to:

[8] *See* Section 1011(a) of the Dodd-Frank Act.

[9] *See id.* at Section 1017(a).

[10] *See id.* at Section 1012(c)(2).

[11] *See id.* at Section 1017(a)(2)(C).

[12] *See id.* at Section 1017(a)(4).

[13] *See id.* at Section 1017(a)(5)(A).

[14] *See id.* at Section 1021.

- Conduct financial education programs;
- Handle consumer complaints;
- Publish information identifying risks to consumers and the proper functioning of markets;
- Supervise covered persons and undertake appropriate enforcement actions;
- Issue rules, orders, and guidance regarding Federal consumer financial law; and
- Perform other activities as necessary to carry out the functions of the Bureau.[15]

To accomplish these functions, the Bureau is statutorily required to maintain specific functional units or offices at the agency. Those statutorily required offices and units include: a research unit, community affairs unit, a unit dedicated to the collection and tracking of consumer complaints, an office of fair lending, office of financial education, office of service member affairs, and an office of financial protection for older Americans.[16] In addition, the Bureau has established several other divisions and offices to carry out its duties.

13.1.2 Overview of Bureau Authority & Covered Persons

The CFPA consolidates in the Bureau many of the federal consumer protection powers previously held by seven other regulators.[17] These regulators included the Officer of Comptroller of the Currency (OCC), National Credit Union Administration (NCUA), FRB, Federal Deposit Insurance Corporation (FDIC), the former Office of Thrift Supervision (OTS), FTC, and the Department of Housing and Urban Development (HUD).[18] Unlike the five prudential regulators, the FTC did not have supervisory authority over nondepositories that fell under FTC jurisdiction. Because state regulators filled that void, supervision standards and procedures were fractured and varied by state.[19]

Generally, the CFPA endowed the Bureau with rulemaking authority over federal consumer financial law (with some exceptions contained in Sections 1027 and 1029 of the Dodd-Frank

[15] *See id.* at Section 1021(c).

[16] *See id.* at Sections 1013(b)-(g).

[17] Congressional Research Service, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, R42572, at 2 (2014), available at https://fas.org/sgp/crs/misc/R42572.pdf.

[18] *Id.*

[19] *Id.* at 3.

Act). The Bureau has supervisory authority over covered persons but also over service providers in various respects. Finally, the Bureau's enforcement authority extends to any person.

Covered persons subject to the Bureau's supervisory authority include depository institutions with over $10 billion in assets and certain nondepository institutions that offer or provide consumer financial products or services. The Bureau can supervise nondepositories of all sizes in the residential mortgage, private education lending, and payday lending markets subject to a risk-based prioritization process.[20] Also, the Bureau may supervise nondepositories that are larger participants in markets for consumer financial products or services, as defined by Bureau rulemakings if the Bureau determines these larger participants pose a risk to consumers.[21]

To date, the Bureau has issued rules defining larger participants in the markets for consumer reporting, debt collection, student loan servicing, international money transfers, and automobile financing and certain automobile leasing activities.[22] Prior to the Dodd-Frank Act, nondepository institutions often competed with banks but were not subject to the same supervision and enforcement. So, the goal for defining larger participants was to capture larger players in each market and obtain a broader view of the issues in those markets. The Bureau also sought to level the playing field between nondepository institutions and depository institutions by making sure both were subject to fair and equal levels of supervision. The Bureau developed larger participant rules by analyzing statistical data and cost-benefit analyses by market. But this data was largely imperfect given that there were no requirements for these nondepositories to register with regulators. The Bureau now has the authority to require these entities to register with the Bureau.[23]

Noticeably, the Dodd-Frank Act explicitly excludes auto dealers from the Bureau's authority. This is the case even though some either directly or indirectly facilitate extensions of credit to consumers like other covered entities.[24] The auto dealer exemption does not apply to those that "offer financing, including leases, directly to consumers and do not routinely assign the loan or lease to an unaffiliated third party; provide services related to real property transactions; or offer any other consumer financial product or service not related to the sale or servicing of

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[20] *See* https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/defining-larger-participants-student-loan-servicing-market/; Section 1024(a)(1) of the Dodd-Frank Act; *id.* at 1024(b)(2).

[21] *See* Section 1024(a)(1)(C) of the Dodd-Frank Act; *id.* at 1024(a)(1)(B). *See also* 12 C.F.R. 1090; 12 C.F.R. 1091.

[22] *See* 12 C.F.R. 1090; 12 C.F.R. §1001.

[23] *See* Section 1022(c)(7) of the Dodd-Frank Act.

[24] *See id.* at Section 1029.

vehicles or boats, as applicable." But most auto dealers fall outside of this exception, and thus escape Bureau oversight.[25]

13.1.3 Bureau Rulemaking Authority

The Bureau has broad rulemaking powers. Generally, it has the authority to implement, administer, and enforce "federal consumer financial law."[26] Federal consumer financial laws means the CFPA, the laws for which authorities are transferred under Subtitles F and H of the CFPA, any Bureau rule or order issued pursuant to the CFPA, and the "enumerated consumer laws."[27] The 18 enumerated consumer laws include:

- The Alternative Mortgage Transaction Parity Act of 1982,
- The Consumer Leasing Act of 1976,
- The Electronic Fund Transfer Act,[28]
- The Equal Credit Opportunity Act,
- The Fair Credit Billing Act,
- The Fair Credit Reporting Act,[29]
- The Homeowners Protection Act of 1998,
- The Fair Debt Collection Practices Act,
- Subsections (b) through (f) of Section 43 of the Federal Deposit Insurance Act,
- Sections 502 through 509 of the Gramm-Leach-Bliley Act,[30]

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[25] *See*, e.g., Foreword, Appendix A; Donald C. Lampe, Ryan J. Richardson, *The Consumer Financial Protection Bureau at Five: A Survey of the Bureau's Activities*, 21 N.C. Banking Inst. 85, 130 (2017).

[26] *See* Section 1022(a) of the Dodd-Frank Act.

[27] *See id.* at 1002(14).

[28] Except for Section 920 of the Electronic Funds Transfer Act, the CFP transferred rulemaking authority for this law from the Federal Reserve to the Bureau. *See id.* at Section 1002(12); *see also* https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/electronic-fund-transfers-regulation-e/.

[29] The CFPA did not transfer to the Bureau authorities under sections 615(e) and 628 of the Fair Credit Reporting Act.

[30] The CFPA did not transfer authority under the Safeguards Rule in the Gramm-Leach-Bliley Act. The FTC has authority over this rule. *See* Section 1002(12)(J) of the Dodd-Frank Act.

- The Home Mortgage Disclosure Act of 1975 (HMDA),
- The Home Ownership and Equity Protection Act of 1994,
- The Real Estate Settlement Procedures Act of 1974 (RESPA),
- The S.A.F.E. Mortgage Licensing Act of 2008,
- The Truth in Lending Act (TILA),
- The Truth in Savings Act,
- Section 626 of the Omnibus Appropriations Act, 2009, and
- The Interstate Land Sales Full Disclosure Act.[31]

Federal regulators have each grappled with the question of how to best implement rules broad enough to cover their respective authorities yet narrowly tailored to prevent over-inclusiveness. Part of this equation is determining whether such rules should be prescriptive, principle-based, or a hybrid of the two.[32] Prescriptive rules provide specific, detailed requirements; whereas principle-based rules describe high-level, broad principles or standards that entities must meet.[33] While prescriptive and principle-based rules both have their merits, there may be circumstances that make one more effective than the other. Given their specificity, prescriptive rules can quickly stale due to changes in circumstance. Principle-based rules are generally thought to be more flexible and adaptive but may lack clarity.[34] The choice between them is discussed in more detail in Chapter 6.

Most of the enumerated consumer laws are prescriptive in nature. However, the CFPA provides the Bureau with another powerful, principle-based tool for addressing bad conduct – its authority to regulate and enforce against unfair, deceptive, or abusive acts or practices (UDAAP).[35] UDAAP's flexibility gives the agency wide latitude in determining whether certain conduct causes harm to consumers. The law provides criteria for conduct considered "unfair"

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[31] *See id.* at Section 1002(12).

[32] See Heath P. Tarbert, Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation, HARVARD BUSINESS LAW REVIEW, Vol. 10 (2019-2020).

[33] See id.

[34] *See* Dan Awrey, *Regulation Financial Innovation: A More Principles-Based Proposal?*, BROOK. J. CORP. FIN. & COM. L., Vol. 5, 274-279 (2011), available at https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1097&context=bjcfcl.

[35] *See* Section 1031 of the Dodd-Frank Act.

and "abusive." The Bureau may undertake rulemaking to further define these standards,[36] but need not do so prior to enforcing them.[37] This flexibility has created a level of uncertainty among covered institutions, especially with respect to the "abusiveness" standard. Since the FTC has long had the authority to prosecute "unfair" and "deceptive" acts, entities can take their cues from robust precedents in those areas to determine whether their conduct will violate the law. But the FTC does not have authority to prosecute "abusive" conduct.[38] The Bureau has had to wade into unchartered waters when applying this standard.[39] In February 2020, the Bureau issued a policy intended to clarify the abusiveness standard, but the uncertainty among covered institutions remains.[40]

In order to support its rulemaking and other functions, the Bureau must monitor risks and trends in the financial marketplace and produce an annual report.[41] The Bureau must consider a rule's potential costs and benefits to consumers and covered persons as well as the impact on specific covered persons described in Section 1026 of the Dodd-Frank Act and the impact on consumers in rural areas.[42] The CFPA also provides the Bureau with the authority to exempt classes of persons or products from a rule or the CFPA.[43] If the Bureau enacts a "significant" rule or order, it is required to assess its effectiveness within the first five years.[44] Beyond this initial assessment, there is no CFPA requirement for the Bureau to continually assess the effectiveness of a rule.[45]

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[36] *See* Section 1031(b) of the Dodd-Frank Act.

[37] *See e.g., Consumer Financial Protection Bureau v. Navient Corporation,* 2017 WL 3380530 (M.S. Pa. 2017). *See also* Section 1031(b) of the Dodd-Frank Act.

[38] *See Section 5 of the FTC Act;* § 8:11. Concurrent Jurisdiction with CFPB, Consumer Protection and the Law § 8:11. The FTC also enforces the Telemarketing Sales Act, which prohibits "abusive" telemarketing practices, but in adopting the National Do Not Call Registry the agency stated that it would identify additional practices as "abusive" "within the purview of its traditional unfairness analysis, as developed in Commission jurisprudence and codified in the FTC Act." *See* Telemarketing Sales Rule, Statement of Basis and Purpose, 68 Fed. Reg. 4580, 4614 (2003).

[39] *See* § 8:11. Concurrent Jurisdiction with CFPB, Consumer Protection and the Law § 8:11.

[40] *See* https://www.federalregister.gov/documents/2020/02/06/2020-01661/statement-of-policy-regarding-prohibition-on-abusive-acts-or-practices.

[41] *See* Section 1022(c)(1) of the Dodd-Frank Act. Additionally, note that the Bureau can require covered persons and supervised entities to provide information in support of its monitoring requirements.

[42] *See id.* at 1022(b)(2)(A).

[43] *See id.* at Section 1022(b)(2)-(3).

[44] *See id.* at 1022(d).

[45] The Regulatory Flexibility Act also requires the Bureau to conduct a review of rules within 10 years of their enactment. *See* https://www.consumerfinance.gov/about-us/newsroom/bureau-outlines-plan-review-rules-under-regulatory-flexibility-act/.

The Bureau's broad rulemaking authorities are subject to some regulatory and legal oversight. The Financial Stability Oversight Council (FSOC) may set aside Bureau regulation that poses a risk to the safety and soundness of the U.S. banking system or the stability of the U.S. financial system, which acts as a check on the Bureau's rulemaking powers.[46] In addition to oversight by the FSOC, the Bureau's rules are subject to review under the Administrative Procedure Act and the Congressional Review Act.

13.1.4 Bureau Supervisory Authority

The CFPA establishes the Bureau as the foremost financial regulatory agency conducting examinations for compliance with federal consumer financial law.[47] The Bureau examines covered persons subject to its supervisory authority to assess their compliance, obtain information about their activities or internal policies, and detect and assess risks to consumers and the financial services market.[48]

The Bureau's authority to supervise and examine covered non-banks is virtually on par with its authority for depository institutions with over $10 billion in assets. With respect to both non-banks and depository institutions, the Bureau is required to coordinate examinations with other federal and state regulators.[49] But for nondepositories, the Bureau is required to scale examinations based on the risk profile of these entities using factors such as asset size, volume of business, and risk to consumers.[50]

Although limited, the Bureau has some authority over depositories with $10 billion or less in assets. Prudential regulators have primary authority to enforce compliance with federal consumer financial law.[51] But the Bureau may require these institutions to provide information

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[46] *See* Section 1023(a) of the Dodd-Frank Act. The members of the Financial Stability Oversight Council include voting members: the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, Comptroller of the Currency, the Chairman of the SEC, the Chairperson of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairman of the NCUA Board, Chairperson of the FDIC, Director of the Bureau, and a presidential appointee; and non-voting members: the Director of the Office of Financial Research, Director of the Federal Insurance Office, a designated state insurance commissioner, a designated state banking supervisor, and a designated state securities commissioner. *See id.* at Section 111.

[47] *See id.* at Section 1024(d), 1025(b).

[48] *See id.* at Section 1024(b)(1), 1025(b)(1).

[49] *See id.* at Section 1024(b)3), 1025(e).

[50] *See id.* at Section 1024(b)(2).

[51] *See id.* at Section 1026(d).

to assist in the Bureau's work[52] and may also participate in exams by prudential regulators on a limited basis.[53]

13.1.5 Bureau Enforcement Authority

The Bureau is also charged with enforcing federal consumer financial law to protect consumers and ensure the markets for federal consumer financial products or services operate fairly. The CFPA gives the Bureau the power to file a civil lawsuit or initiate an administrative proceeding before an administrative law judge to enforce compliance with federal consumer financial law.[54] The Bureau has a number of civil remedies available to it including: rescission or reformation of contracts; refund of moneys or return of real property; restitution; disgorgement or compensation for unjust enrichment; payment of damages or other monetary relief; limiting the activity of the violator; notifying the public of the violation and recouping associated fees; and civil money penalties.[55] The Bureau may also recover costs associated with pursuing an action against a violator. However, it cannot recover exemplary or punitive damages.[56]

The CFPA establishes a three-tiered structure for the assessment of penalties. As of the effective date of the CFPA, a court or administrative body could assess a penalty of up to $5,000 (Tier 1), $25,000 (Tier 2), or $1,000,000 (Tier 3) for each day a violation of law continued.[57] The per-day penalty amount is based on whether the entity violated the law a) without knowledge or recklessness (Tier 1); b) recklessly (Tier 2); or c) knowingly (Tier 3). These amounts are adjusted annually due to inflation pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990.[58] The Bureau has the authority to compromise, modify, or remit any penalty a court or the Bureau assesses.[59] Generally, the Bureau maintains that it determines an appropriate penalty by considering the number of violations of a consumer financial law and the number of consumers harmed by the violation, and then applying the mitigating factors.[60]

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[52] *See id.* at Section 1026(b).

[53] *See id.* at Section 1026(c)(1).

[54] See Adam J. Levitin, The Consumer Financial Protection Bureau: An Introduction, 32 REV. BANKING & FIN. L. at 357.

[55] *See* Section 1055(a)(2) of the Dodd-Frank Act.

[56] *See id.* at 1055(a)(3).

[57] *See* Consumer Financial Protection Bureau, *Office of Enforcement Policies and Procedures Manual,* V. 3.0 (2017).

[58] The current penalties are: Tier 1 - $5,883; Tier 2 - $29,416; and Tier 3 - $1,176,638. *See* 12 C.F.R. 1033.

[59] *See* Section 1055(c) of the Dodd-Frank Act.

[60] *See* Office of Enforcement Policies and Procedures Manual, *supra* note 57, at 125.

The six mitigating factors the Bureau is required to consider include:

- Size of financial resources
- Good faith
- Gravity of the violation or failure to pay
- Severity of the risks to or losses of the consumer
- History of previous violations [and]
- Such other matters as justice may require.[61]

The Bureau's penalty structure has been criticized given its broad discretion to seek penalties and the perceived lack of transparency regarding the Bureau's penalty calculations. The high maximum penalty amounts for each tier can potentially generate maximum penalties out of proportion to any harm to consumers.[62] The Bureau's power to impose penalties has generated two types of concern.

With respect to the Bureau's enforcement powers and relationship with the FTC, the Bureau's remedial powers are much greater and easier to use than the FTC's. For example, with respect to unfair or deceptive acts or practices under Section 5 of the FTC Act, the maximum penalty amount the FTC can assess is $43,280 per violation.[63] Conversely, the Bureau can assess penalties of up to $1 million per day (or per consumer) for a "knowing" violation. As a result, with respect to enforcement actions that could be pursued by either agency, there is a concern that the lack of consistency between these two agencies could lead to two similarly-situated parties receiving different punishments based on the happenstance as to whether a case happens to be brought by the FTC or CFPB. In the alternative, the CFPB and FTC could assign a dispute to one party or the other depending on their relative ability to obtain differential remedies, instead of their expertise in the matter. To prevent this result, the Taskforce urges Congress to review the remedies available to the CFPB and FTC and, where reasonably possible, increase the consistency of treatment between the two agencies.

With respect to the CFPB's relationship to prudential regulators, the CFPB's possible remedies are thought potentially to be more unpredictable than the prudential regulators for similar acts.

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[61] *See id. See also* Section 1055(c)(3) of the Dodd-Frank Act.

[62] Although in theory the penalties available are required to be subjected to mitigation review, most enforcement actions are settled, not litigated.

[63] *See* 16 C.F.R. § 1.98.

Prudential regulators have provided public matrices of factors they will use in determining what remedies to seek in any given case. The CFPB, however, has chosen not to adopt a matrix of factors it will consider when seeking remedies, which leads to the possibility of inconsistent treatment from the CFPB and prudential regulators in any given case. Additionally, neither the Bureau's internal policy nor the CFPA provide concrete rules on how to determine the severity of a violation, i.e., whether the Bureau should seek the maximum per-day penalty or a lesser amount. That determination is largely within the Bureau's discretion provided it takes into account the statutory mitigating factors. This uncertainty is unnecessary and contrary to the rule of law, leading to a zone of uncertainty that can deter valuable economic activity.

13.1.6 Express Limitations on the Bureau's Authority

Although the Bureau's authority is vast, it is not unlimited. In addition to the exclusion from the Bureau's authorities with respect to auto dealers described above, Section 1027 of the Dodd-Frank Act contains other express limits on the Bureau's authority. The Bureau cannot exercise its authority over any merchant, retailer, or seller of any nonfinancial good or service except to the extent they offer a consumer financial product or service or are subject to consumer financial laws specified in the Act.[64] Additionally, the Bureau generally does not have authority over a merchant, retailer, or seller who extends credit to a consumer (or collects or sells related debt) for the purpose of enabling the purchase of a non-financial product.[65] Both of these limitations are subject to certain restrictions.[66]

Generally, the usual activities of real estate brokers, accountants or accounting firms, and attorneys are outside the Bureau's authority. Similarly, the Bureau generally does not have authority over agents or brokers of a buyer or seller of a manufactured or modular home or facilitators or negotiators of contracts for those homes. The Bureau also generally does not have authority over persons regulated by a state insurance regulator, a state securities commission, the U.S. Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or the Farm Credit Administration. Generally, each of the aforementioned limitations apply only in so far as the actor is not engaged in the offering or providing of consumer financial products or services, or the actor is not engaged in an activity that is subject to a consumer law for which the Dodd-Frank Act transferred authority to the Bureau.[67]

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[64] *See* Section 1027(a)(1) of the Dodd-Frank Act.

[65] *See id.* at Section 1027(a)(2).

[66] *See id.* at Section 1027(a)(2)(A).

[67] *See id.* at Section 1027.

Furthermore, the Bureau generally cannot exercise its authority over the solicitation or making of voluntary contributions to certain tax-exempt organizations.[68] And the Bureau generally cannot exercise authority over employee benefit and compensation plans or arrangements and a number of specified plans under the Internal Revenue Code ("specified plans or arrangements").[69] Like other limitations imposed on the Bureau, the exemptions covering tax-exempt contributions and specified plans or arrangements apply only if the activity does not constitute a provision of financial products or services and the activity is not subject to an enumerated consumers law or a consumer law for which the Dodd-Frank Act transferred authority to the Bureau.

In addition to the limitations pertaining to certain activities, the Bureau cannot define insurance as a "financial product or service."[70] It also does not have authority to impose a usury limit on an extension of credit.[71]

13.1.7 Bureau Authority Post-*Seila Law*

It is against this regulatory backdrop that we consider the ramifications of the U.S. Supreme Court's recent decision in *Seila Law v. Consumer Financial Protection Bureau.*[72] Since its inception, there have been numerous challenges to the Bureau's structure.[73] The most recent successful challenge to the Bureau's structure in *Seila Law* resolves some questions while leaving others in its wake. The Supreme Court's decision reinforced the Bureau's authority while cementing the Bureau's position as a fixture in the consumer financial services landscape. But the decision also creates small pockets of confusion that could negatively impact the stability of the financial regulatory space and beyond.

In 2017, the Bureau issued a civil investigative demand (CID) to a law firm concerning its debt-related services. The law firm, Seila Law LLC, refused to respond to the CID on the grounds that the Bureau's structure was unconstitutional. The law firm argued that the Bureau's single-director structure violated the Separation of Powers doctrine in the Constitution since the

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68 *See id.* at Section 1027(l).

69 *See* Sections 220, 223, 401(a), 403(a), 403(b), 408, 408A, 529, or 530 of the Internal Revenue Code of 1986.

70 *See* Section 1027(m) of the Dodd-Frank Act.

71 *See id.* at Section 1027(o).

72 See Seila Law LLC v. Consumer Fin. Prot. Bureau, 140 S. Ct. 2183 (2020).

73 § 6:1.Enforcement, Prac. Guide to Consumer Fin. Protection Bureau Regs. § 6:1.

President could only remove the Director for cause. The Bureau brought an action to enforce the CID and the case made its way to the Supreme Court.

In contrast to lower court rulings in favor of the Bureau, the Supreme Court found that the single-director structure was unconstitutional.[74] The Court noted that the President's removal power is quintessentially executive in nature as it provides the President with the ability to exercise control over presidential appointees.[75] The Court determined that the President's ability to exercise removal power "is the rule, and not the exception."[76]

The Court identified two recognized exceptions to the President's broad removal powers: "one for multimember expert agencies that do not wield substantial executive power, and one for inferior officers with limited duties and no policymaking or administrative authority."[77] The first exception comes from the *Humphrey's Executor* case. In that case, the Court upheld a statute protecting FTC Commissioners from removal except in the case of their "inefficiency, negligent of duty, or malfeasance in office." The *Humphrey's Executor* Court believed, "[r]ightly or wrongly,[78]" that the FTC acted as a quasi-legislative, quasi-judicial agency that did not exercise any executive powers at the time the case was decided.[79] In *Seila Law*, Chief Justice Roberts emphasized that the organizational structure in *Humphrey's Executor* differed from the Bureau's in that the FTC's leadership consisted of a non-partisan, five-member board of commissioners. Additionally, FTC Commissioners were expected to use their combined cumulative expertise rather than politics to direct agency actions.[80] Moreover, *Humphrey's Executor* rested on the conclusion that the FTC exercised no executive authority at the time the case was decided; whereas the Bureau exercised significant executive authority.

The second exception to the President's removal powers applies to "inferior officers" of the executive branch with limited duties and no policymaking or administrative authority.[81] In *Morrison v. Olson*, the Court determined an independent counsel was an inferior officer because he had limited jurisdiction and tenure and lacked policymaking or significant administrative

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74 *See Seila Law*, 140 S. Ct. 2183.

75 *See id.* at 2197.

76 *See id.* at 2190.

77 *See id.* at 2197.

78 *See id.* at 2198.

79 *See id.* At the time *Humphrey's Executor* was decided, the FTC's executive powers were scarce, unlike today's FTC, which wields extensive executive power.

80 *See id.* at 2198-99.

81 *See U.S. v. Perkins*, 6 S. Ct. 449 (1886); *Morrison v. Olson*, 108 S.Ct. 2597 (1988).

authority.[82] In contrast to the limited scope of the authority exercised by the independent counsel, the Court found that the Bureau exercises broad authority to issue regulations, investigate potential violations of the law, and to impose potentially substantial penalties on private actors.[83]

With respect to both exceptions, the *Seila Law* Court believed that the central question was whether the restriction on removal impeded the President's ability to perform their constitutional duties, which would render the restriction unlawful.[84] The Court found that the Director's for-cause removal restriction impeded the President's ability to perform essential functions contrary to *Humprhrey's Executor* and *Morrision.* The Court also declined to establish a third exception to cover the Bureau's leadership structure. Relying on the Dodd-Frank Act's severability clause, the Court found that the offending for-cause removal provision could be severed from the Act, leaving the law and the Bureau's authority intact. The Court reasoned that "Congress would prefer that [the Court] use a scalpel rather than a bulldozer in curing the constitutional defect."[85]

For many, the *Seila Law* opinion was somewhat unsatisfying and confusing. One commentator, for example, argues that the Court's opinion was doomed to confuse scholars and the public because the Supreme Court's for-cause removal precedent is confusing.[86] As an illustration of the potentially confusing nature of removal precedent, the Court has cited the presence of accumulated expertise among agency leadership as a factor weighing in favor of upholding a statutory removal restriction. But the link between this expertise and the separation of powers doctrine seems tenuous. Although consistent agency leadership has clear benefits, it is unclear why these benefits affect the question of whether it is appropriate for agency leadership to exercise executive authority.

Seila Law does not specifically define what distinguishes an "independent agency" from an "executive agency." Instead, it falls back on the conventional description of a "traditional

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[82] *See Morrison,* 108 S.Ct. 2597.

[83] *Seila Law,* 140 S. Ct. at 2200-01.("It is true that the independent counsel in Morrison was empowered to initiate criminal investigations and prosecutions, and in that respect wielded core executive power. But that power, while significant, was trained inward to high-ranking Governmental actors identified by others, and was confined to a specified matter in which the Department of Justice had a potential conflict of interest. By contrast, the CFPB Director has the authority to bring the coercive power of the state to bear on millions of private citizens and businesses, imposing even billion-dollar penalties through administrative adjudications and civil actions.").

[84] See *id.* at 2199.

[85] *Id.* at 2210-2211.

[86] *See* Jerry L. Marshaw, *Of Angels, Pins, and For-Cause Removal: A Requiem for the Passive Virtues,* THE UNIVERSITY OF CHICAGO LAW REVIEW ONLINE (2020), available at https://lawreviewblog.uchicago.edu/2020/08/27/seila-mashaw/.

independent agency headed by a multimember board or commission."[87] The Court noted that the initial legislative proposal that introduced the idea of a new consumer financial protection agency "envisioned a traditional independent agency, run by a multi-member board with a 'diverse set of viewpoints and experiences.'"[88] The Court apparently found it unnecessary to provide an exact definition of an "independent agency" to conclude that CFPB constituted one. Implicitly, however, the Court defined an independent agency as one in which there are limits placed on the President's power to remove officers.[89] The Court concluded that an independent agency led by a single director and vested with significant executive power was unconstitutional.[90]

So, the question of whether the Bureau, or any other similarly structured agency, is an independent agency remains. It is possible that the Court chose not to address the issue because the binary classification of an agency as either an executive or independent agency may not be a useful distinction under the circumstances. Agency "independence" is typically a matter of degree, and its characteristics lie upon a continuum, not a binary categorization. The administrative requirements an agency must follow also vary and appear to be a function of whatever Congress requires in the agency's enabling legislation. In other words, there do not appear to be special administrative requirements, such as a requirement to obtain budgetary approval from Congress, that apply to executive agencies but not independent agencies and vice versa. Perhaps an independent agency is simply an agency that has some degree of independence and falls outside of the Executive Office of the President and executive departments.[91] On the other hand, commenters have argued that the power of the President to remove the head or heads of an agency is the *sine qua non* of an agency's constitutionality, being both necessary and sufficient.[92]

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87 *Seila Law*, 140 S. Ct. at 2191.

88 *See id.* at 2192.

89 Some scholars have questioned whether in practice limits on the President's power to remove agency officers has been considered to be the defining characteristic of an independent agency. This has led some to reject the idea of executive and independent agencies as falling in discrete binary categories but instead, they fall on a continuum that ranges from agencies directly controlled by the President to those with the most independence. *See* Kirti Datla & Richard L. Revesz, *Deconstructing Independent Agencies (and Executive Agencies)*, 98 Cornell L. Rev. 769, 772-79 (2013)

90 *See id.* at 773.

91 *See* Administrative Conference of the United States, *Sourcebook of United States Executive Agencies*, 2d ed., 42-43 (2018), available at https://www.acus.gov/sites/default/files/documents/ACUS%20Sourcebook%20of%20Executive%20Agenices%202d%20ed.%20508%20Compliant.pdf.

92 See Neomi Rao, Removal: Necessary and Sufficient for Presidential Control, 65 ALA. L. REV. 1205, 1227 (2014).

Seila Law potentially leaves open the possibility that the Supreme Court might hold in the future that the President must have the power to remove the leaders of multi-member agencies at will, if they are deemed to exercise significant executive power. While declining to revisit its decision in *Humphrey's Executor* "today," *Seila Law* noted that the ability to seek substantial monetary penalties against private parties on behalf of the United States in federal court is a "quintessentially executive power not considered in *Humphrey's Executor*."[93] The Court did not address whether a multi-member agency's exercise of that or some other quintessentially executive power might be grounds for distinguishing *Humphrey's Executor*.

The Court provided limited guidance about the ratification of Bureau actions undertaken while the for-cause removal protection was in place.[94] Instead, the Court recognized the existence of a live dispute about ratification that turned on "case-specific factual and legal questions" that would be more appropriately addressed by the lower courts in the first instance.[95]

13.1.8 Contested Areas of Bureau Authority

Apart from *Seila Law*, there have been other challenges to the outlines of the Bureau's authority. Given the Bureau's relative youth, it is still exploring the bounds of its authority in several areas. For example, there has been some debate regarding whether the Bureau has authority over rent-to-own transactions. The uncertainty revolves around whether these transactions constitute installment loans, which are within the Bureau's jurisdiction, or short-term leases, which may not be depending on their duration.[96] In 2011 testimony before Congress, the FTC noted that the Bureau had not made a determination regarding its authority with respect to these transactions although the FTC noted the Bureau has rulemaking authority for laws related to credit and lease transactions.[97] In 2015, Senator Bob Casey sent a letter to the Bureau urging it to investigate consumer protection issues in the rent-to-own industry.[98] The Bureau ultimately decided to push forward with investigating these entities in 2017 and issued a CID to a rent-to-own

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93 *See Seila Law,* 140 S. Ct. at 2200-01.

94 *See id.* at 2208.

95 See id.

96 *See e.g.* https://www.huffpost.com/entry/rent-a-center-cfpb-richard-cordray_n_1250033. The Bureau has the authority to regulate leases for real or personal property that are purchase finance agreements if the term of the lease is at least 90 days. *See* Section 1002(15)(A)(ii)(II) of the Dodd-Frank Act.

97 Prepared Statement of the Federal Trade Commission on Rent-to-Own Transactions: Hearing Before the H. Comm. on Fin. Servs. Financial Institutions and Consumer Credit Subcomm., p. 2 (July 26, 2011) (testimony of Charles Howard), available at https://www.ftc.gov/sites/default/files/documents/public_statements/prepared-statement-federal-trade-commission-rent-own-transactions/110726renttoowntestimony.pdf.

98 *See* January 22, 2015 Correspondence, available at https://www.casey.senate.gov/newsroom/releases/casey-presses-federal-watchdogs-on-consumer-protections-in-rent-to-own-industry.

company Rent-A-Center. Although Rent-A-Center petitioned the Bureau to set aside the CID because the Bureau lacked authority over the company, the Bureau declined to do so. The Bureau did not find that it had authority over rent-to-own companies as a general matter. Instead, it argued that the Dodd-Frank Act and case precedent conferred authority to issue a CID to investigate whether Rent-A-Center's conduct fell within the Bureau's jurisdiction.[99] As it stands, the Bureau has not initiated an enforcement action against the company, and the question of whether rent-to-own companies fall under the Bureau's jurisdiction remains unsettled.

The Bureau has also tested its jurisdictional boundaries with respect to its authority over for-profit education lending matters. In 2014, the Bureau filed a complaint against ITT Educational Services, Inc. (ITT), pursuant to its UDAAP and TILA authorities. The Bureau alleged ITT used aggressive tactics to coerce students into taking out private loans despite knowing most students lacked the ability to repay them.[100] ITT moved to dismiss the complaint, arguing that it did not provide consumer financial products and that the alleged conduct fell outside the Bureau's authority since the loans were financed by a third party.[101] In denying ITT's Motion to Dismiss, the court found that the Bureau sufficiently alleged facts to show that ITT was a "covered person" and "service provider" under the CFPA. The court noted that ITT's alleged conduct qualified as the provision of "financial advisory services," and that ITT was "heavily involved" in operating and maintaining the loan program although it was directly run by third parties. Therefore, the alleged conduct fell under the Bureau's authority. ITT and the Bureau ultimately settled the action.[102]

Conversely, in an action against the Accrediting Council for Independent Colleges and Schools (ACICS), a federal district court found that the Bureau exceeded its authority by issuing a CID to ACICS given the Bureau's authority did not extend to the accreditation process. On appeal, the Bureau argued that the district court had incorrectly cabined the scope of the Bureau's investigation – the Bureau was investigating not just accreditation but instead was seeking to identify unlawful practices that may have occurred *in connection with* the accreditation of for-

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99 *See* Bureau's Decision and Order on Petition by Rent-A-Center to Set Aside or Modify Civil Investigative Demand (2017), available at https://files.consumerfinance.gov/f/documents/cfpb_petition-to-modify_rent-a-center-inc_decision-and-order.pdf.

100 *See* Order on Defendant's Motion to Dismiss, *Consumer Financial Protection Bureau v. ITT Educational Services, Ince.*, pp. 2 and 6 (S.D. Ind. 2015)(No. 1:14-cv-00292), available at https://www.govinfo.gov/content/pkg/USCOURTS-insd-1_14-cv-00292/pdf/USCOURTS-insd-1_14-cv-00292-0.pdf.

101 *See* ITT's Statement, available at http://www.ittesi.com/2014-04-30-ITT-Educational-Services-Inc-Calls-CFPB-Complaint-Unfounded-Asks-Court-To-Dismiss.

102 *See* the Bureau's Press Release announcing the settlement, available at https://www.consumerfinance.gov/about-us/newsroom/bureau-settles-lawsuit-against-itt-educational-services/.

profit colleges. The circuit court did not make any findings of fact regarding the authority of the Bureau to investigate accredited institutions' lending practices, or practices in connection with accreditation. Instead, it issued a narrower ruling, finding that the Bureau's CID failed to notify ACICS of the nature of the alleged violations underlying the investigation, and therefore the Bureau's CID exceeded its authority.[103] At least one commenter argues the court's decision implies that courts believe the Bureau owes more deference to challenges to CIDs from entities that receive a CID but are not alleged to have committed any unfair, deceptive, or abusive acts themselves.[104]

Aside from rent-to-own companies and for-profit educational institutions, the Bureau has also tested its authority over wireless carriers. In 2014 and 2015, the Bureau brought UDAAP actions against wireless carriers Sprint and Verizon, respectively. The complaints alleged Sprint and Verizon operated their billing systems in a way that allowed third parties to "cram" unauthorized charges on customer accounts, such as charges for ringtones and "premium" text messages.[105] The Bureau alleged that Sprint, for example, automatically opted customers into third-party billing without obtaining their consent and failed to adequately address customer billing complaints.[106] Both companies received a 30-40 percent cut of the gross revenue from these third-party charges to customers.[107]

Although neither Sprint nor Verizon are traditional financial services companies, the Bureau alleged the wireless carriers were, nonetheless, "covered persons" under the Dodd-Frank Act because they provided consumer financial products or services by extending credit to and processing payments for goods and services provided by third parties.[108] In a public statement, Sprint lamented the Bureau's decision to use the matter as a "test case" to determine its

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[103] *See Consumer Fin. Prot. Bureau v. Accrediting Council for Indep. Colleges & Sch.*, 854 F.3d 683, 692 (D.C. Cir. 2017).

[104] *See* E. S. Kisluk, *Fishing" for Trouble?: On the Appropriate Limits of a Civil Investigative Demand Issues by the CFPB*, 21 N.C. BANKING INST. 299, 325 (2017), available at http://scholarship.law.unc.edu/ncbi/vol21/iss1/16.

[105] *See* Sprint Complaint, *CFPB v. Sprint Corporation*, No. 0:14-cv-9931 (S.D.N.Y. May 12, 2015), available at https://files.consumerfinance.gov/f/201412_cfpb_cfpb-v-sprint-complaint.pdf; Verizon Complaint, *CFPB v. Cellco Partnership d/b/a Verizon Wireless*, No. 3:15-cv-03268 (D. NJ. May 12, 2015), available at https://files.consumerfinance.gov/f/201505_cfpb-cfpb-v-verizon-complaint.pdf.

[106] *See* Sprint Complaint, at 20, 24-25.

[107] *See* https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-to-obtain-120-million-in-redress-from-sprint-and-verizon-for-illegal-mobile-cramming/.

[108] *See* Sprint Complaint, at 9; Verizon Complaint, at 10.

authority over wireless carriers.[109] Sprint and Verizon settled the action with the Bureau by agreeing to pay $120 million in consumer refunds and additional $38 million in fines.[110]

Most agree that the Bureau's authority is broad, but there is still some uncertainty about its exact parameters. Some of the uncertainty may be due to ambiguities in the Dodd-Frank Act and court interpretations of the same, but other uncertainty may simply be the result of a relatively young agency trying to chart its own path.

13.2 Authority of Other Federal Agencies and Prudential Regulators

With the creation of the Bureau, the Dodd-Frank Act consolidated consumer protection functions exercised by seven agencies into one.[111] The Act simultaneously transferred the primary responsibilities for many consumer protection functions to the Bureau while also reinforcing the authority of preexisting regulators. In doing so, it created additional areas of jurisdictional overlap and the potential for redundancies. Today, multiple federal agencies work independently and together to ensure the strength and safety of the financial market. Overlap occurs in each of the Bureau's jurisdictional areas. Appendices A and B provide an overview of the complex federal financial regulatory framework.

There are five main regulatory entities that have overlapping authority with the Bureau – the FRB, the OCC, the FDIC, the NCUA (the "Depository Regulators"), and the FTC.

[109] *See* https://www.marketwatch.com/story/cfpb-testing-its-reach-in-lawsuit-against-sprint-billing-practices-2014-12-19.

[110] *See* https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-to-obtain-120-million-in-redress-from-sprint-and-verizon-for-illegal-mobile-cramming/.

[111] The Dodd-Frank Act dissolved the Office of Thrift Supervision. Additionally, the Dodd-Frank Act transferred HUD's rulemaking authorities for the Real Estate Settlement Procedures Act to the Bureau and reinforced HUD's jurisdiction over the Fair Housing Act. *See* Section 1027(s) of the Dodd-Frank Act.

13.2.1 FRB

The Federal Reserve System is the nation's central bank.[112] Congress created the Federal Reserve System to foster a financial system that was safer, adaptable, and more stable.[113] The FRB is the agency arm of the Federal Reserve System and is made up of seven presidential appointees. The agency oversees bank holding companies and certain subsidiaries, savings and loan holding companies, state-chartered banks that have elected to join the Federal Reserve System, Edge Act and Agreement Corporations, institutions the FSOC has deemed "systemically significant,"[114] certain nonbank financial companies, and certain insurance holding companies.[115] The FRB has rulemaking, supervisory, and enforcement authority over regulated entities. Through the exercise of these authorities, it provides safety and soundness, consumer protection, and financial system risk oversight. Aside from regulating institutions, the FRB conducts U.S. monetary policy, operates and regulates parts of the payment system, and serves as a lender to banks, among other activities.

13.2.2 OCC

The OCC is the chartering authority and primary regulator of nationally chartered banks under the National Bank Act, federally chartered thrift institutions under the Home Owners' Loan Act,[116] and U.S. federal branches of foreign banks.[117] The OCC provides consumer protection and safety and soundness oversight for these entities through its rulemaking, supervisory, and enforcement powers.[118] Its enforcement powers include the ability to revoke national charters and issue cease and desist orders.[119]

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112 *See* https://www.federalreserve.gov/aboutthefed/structure-federal-reserve-system.htm.

113 *See* https://www.federalreserve.gov/faqs/about_12594.htm#:~:text=Ask%20Us-,What%20is%20the%20purpose%20of%20the%20Federal%20Reserve%20System%3F,stable%20monetary%20and%20financial%20system.

114 For example, financial market utilities participating in payment clearance and settlement.

115 *See* https://www.federalreserve.gov/aboutthefed/files/pf_5.pdf.

116 *See* https://www.occ.treas.gov/about/what-we-do/index-what-we-do.html.

117 Congressional Research Service, *Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework title*, R44918, at 8 (2020), available at https://fas.org/sgp/crs/misc/R44918.pdf.

118 *See* https://www.occ.treas.gov/about/what-we-do/index-what-we-do.html.

119 *See* CRS Report R44918, *supra* note 117, at 14.

13.2.3 FDIC

Congress created the FDIC in response to the Great Depression to protect consumer assets by insuring deposits at financial institutions. The FDIC has primary supervisory and enforcement authority over state-chartered banks and thrifts that are not members of the Federal Reserve System and FDIC-insured branches of foreign banks.[120] The FDIC may also exercise regulatory authority over almost all federally insured institutions by issuing rules and examining institutions for potential risks.[121] The Dodd-Frank Act also gave the FDIC authority to remedy issues with failing or troubled covered financial companies, brokers and dealers.[122] Similar to the FRB, the FDIC examines regulated entities for safety and soundness, consumer protection compliance, and risks to the financial system.

13.2.4 NCUA

The NCUA insures, regulates, and charters federally insured credit unions. These credit unions can include both federally and state-chartered credit unions, the latter of which may elect to become federally insured. Like the Bureau, the NCUA has rulemaking, supervisory, and enforcement powers. NCUA examines credit unions for safety and soundness but also consumer protection compliance.

The Depository Regulators and the Bureau both exercise jurisdiction over insured depository institutions with over $10 billion in assets ("Larger Depository Institutions"), insured depository institutions with $10 billion or less in total assets that are affiliates of Larger Depository Institutions, and other affiliates of Larger Depository Institutions.[123]

13.2.5 FTC

The FTC regulates nondepository institutions that provide consumer financial products or services in addition to regulating other entities. Consumer protection is one of the agency's

[120] See *12 U.S.C. 1820(b); see also CRS Report* R44918, supra note 117, at 14.

[121] *See* https://www.fdic.gov/about/strategic-plans/strategic/supervision.html.

[122] *See* CRS Report R44918, *supra* note 117, at 14.

[123] *See* Joint Memorandum of Understanding on Supervisory Coordination (2012), available at https://files.consumerfinance.gov/f/201206_CFPB_MOU_Supervisory_Coordination.pdf.

central missions. It can exercise rulemaking, investigative, and enforcement authority to that end. Unlike the Depository Regulators and the Bureau, the FTC lacks supervisory authority.[124]

The FTC and the Bureau have shared jurisdiction over certain nondepositories, although the Bureau's authority is broader, including rulemaking and supervision. The CFPA transferred enforcement authority for the enumerated consumer financial laws to the Bureau, but the FTC retained the power to enforce violations of these laws and its unfair and deceptive acts and practices enforcement authority.[125] The FTC and the Bureau also have shared authority over other laws including the Military Lending Act, which both the FTC and the Bureau can enforce.[126] The FTC enforces a number of consumer protection and antitrust laws and has the authority to seek civil penalties for violations of some of those laws.[127]

13.2.6 Coordination

The CFPA and financial regulators have tried to resolve potential confusion and uncertainty caused by jurisdictional overlap in various ways. First, the law attempts to carve out the parameters of each regulator's authority. With respect to institutions with $10 billion in assets or less, the CFPA provides that prudential regulators have primary examination authority and exclusive enforcement authority for violations of the laws under the Bureau's jurisdiction.[128] The Bureau has exclusive supervisory authority for assessing compliance with federal consumer financial laws at depository institutions with more than $10 billion in assets, as well as their affiliates.

The CFPA also encourages coordination among federal regulators and prudential regulators. The Act includes a general requirement for the Bureau to coordinate its activities with prudential regulators, other federal regulators, and state regulators to the extent possible.[129] In addition to the general coordination requirement, the CFPA explicitly requires the Bureau to consult with prudential regulators and other relevant agencies prior to proposing a rule and during the rule's comment period.[130] Although other regulators do not have the authority to veto

[124] *See* https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority.

[125] *See* Section 1061(b)(5) of the Dodd-Frank Act; Section 5 of the FTC Act.

[126] *See e.g.* https://www.ftc.gov/news-events/media-resources/consumer-finance. Additionally, note that the Department of Defense has rulemaking authority for the Military Lending Act.

[127] *See* https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority.

[128] *See* Section 1026(d)(1) of the Dodd-Frank Act.

[129] *See e.g. id.* at Section 1015.

[130] *See id.* at Section 1022(b)(2)(B).

a proposed rule, the Bureau is required to publish a regulator's objection at the time it issues its final rule. Additionally, the FSOC, composed of representatives from various financial regulatory agencies, has the authority to set aside any rule that poses a risk to the safety and soundness of the U.S. banking system or the stability of the U.S. financial system.[131]

The Bureau is also required to coordinate its supervisory activities. The CFPA requires the Bureau to coordinate exam schedules, conduct simultaneous exams if possible, and share draft examination reports with prudential regulators.[132] The Bureau is also required to use preexisting information a depository institution has provided to a federal or state regulator to complete its supervisory functions to the extent possible.[133] With respect to nondepositories, the Bureau is required to coordinate its supervisory activities with the prudential regulators and relevant state agencies.[134]

Agencies also coordinate on enforcement matters. One of the most apparent areas of regulatory overlap is in enforcement actions against unfair and deceptive acts. For example, prior to the Bureau, the FDIC, FTC, OCC, and FRB enforced the FTC's rule prohibiting unfair and deceptive credit practices.[135] Although the FTC's rule did not directly apply to banks, credit unions, and thrifts, given they are outside of its jurisdiction, financial regulators adopted rules substantially similar to that of the FTC. The Dodd-Frank Act effectively transferred rulemaking authority for deceptive and unfair acts from these financial regulators to the Bureau. To resolve potential confusion, the Bureau, FTC, FDIC, OCC, FRB, and NCUA issued joint guidance clarifying their roles in prosecuting unfair and deceptive practices. Additionally, the agencies cautioned that the new prohibitions against unfair and deceptive practices in the CFPA encompassed conduct similar to what is outlawed in the FTC Act.[136]

Memorandums of Understanding (MOU) are yet another tool that financial regulators use to mitigate jurisdictional conflicts. An MOU is an unenforceable written agreement in which each party agrees to conduct itself in a certain way pursuant to a framework that is usually detailed in the document. An MOU is used to encourage coordination and cooperation between the Bureau

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[131] *See id.* at Section 1023(a).

[132] *See id.* at Section 1025(e)(1). *See also id.* at Section 1024(b)(3).

[133] *See id.* at Section 1025(a)(3).

[134] *See id.* at Section 1024(b)(3).

[135] *See* Interagency Guidance regarding Unfair or Deceptive Credit Practices (Aug. 2014) https://www.fdic.gov/news/financial-institution-letters/2014/fil14044a.pdf; Catherine M. Sharkey, *Agency Coordination in Consumer Protection*, 2013 U. CHI. LEGAL F. 329 (2013).

[136] *See* Interagency Guidance regarding Unfair or Deceptive Credit Practices, *supra* note 135, at note 157.

and an external party, i.e., generally, a federal or state agency or an organization with a shared mission or interest. That shared mission or interest might take the form of, among other things, an investigation into alleged misconduct, the establishment of policies for financial institutions, tracking financial literacy data, or a general commitment to protect American consumers. For example, the CFPA requires the Bureau and the FTC to establish an MOU given their overlapping jurisdiction. The Bureau and the FTC established at least four MOUs aimed at coordinating their activities. In a 2019 MOU, the Bureau and the FTC agree to share information regarding targets of investigations, proposed or final rulemakings, and planned enforcement actions. [137] The MOU also provides that the FTC and Bureau will not initiate separate enforcement actions against a covered person at the same time. Additionally, the Bureau agrees to share its exam schedule, and upon request, its exam reports. [138]

The process of establishing an MOU can take time and protracted negotiations between parties. Each party comes to the table desiring to craft an agreement that meets its own organizational needs and standards, and each party may approach the negotiations with a different understanding of what that means. But generally, federal regulators view the process of establishing an MOU as a positive step toward cooperation, and therefore, worthwhile.

13.2.7 Benefits and Drawbacks of Overlapping Authority

Overlapping authority adds additional levels of oversight to the consumer financial markets. It affords regulators several "bites at the apple" to uncover noncompliance and potentially harmful conduct, which ultimately benefits consumers. It also gives financial firms more than one opportunity to "present their case" before a regulator, potentially increasing the odds of unbiased outcomes. [139] Additionally, jurisdictional intersections provide agencies with an opportunity to benefit from each other's respective expertise. The FTC, for example, was created almost 100 years prior to the Bureau. Over the course of its existence, the FTC has developed expertise with investigating and prosecuting consumer protection issues including data breach cases. While both the FTC and Bureau have authority over nondepositories, including credit reporting agencies, the FTC used its expertise to take a lead role investigating the most recent

[137] *See* Memorandum of Understanding between the Consumer Financial Protection Bureau and the Federal Trade Commission (2019).

[138] *See id.*

[139] *See e.g.* Government Accountability Office, *Financial Regulation Complex and Fragmented Structure Could be Streamlined to Improve Effectiveness*, GAO-16-175 (2016), available at https://www.gao.gov/assets/680/675400.pdf.

data breaches. This ultimately advantages regulators, regulated entities, and consumers alike – all of whom benefit from a uniform understanding of the law and consistent enforcement.

Despite best efforts to coordinate functions, the overlapping authority also creates opportunities for redundancy and waste. It increases the risk that no one regulator has a complete picture of an institution, resulting in compliance concerns slipping through the cracks. Additionally, it forces institutions to expend resources preparing for multiple exams by multiple regulators and raises the likelihood that a regulated entity receives conflicting feedback. These drawbacks are to the detriment of consumers who may pay the price for regulators' mishandling of compliance issues or the actual cost of regulatory compliance if an institution increases the price of products or services or implements fees to cover compliance costs.

Overall, overlapping authority among financial regulators may benefit regulators, consumers, and financial institutions. But regulators may need to continue considering ways to streamline their efforts to prevent unwanted redundancy and confusion.

13.3 Federalism

States also play a role in the financial regulatory landscape. But the extent to which they should is an ever-growing subject of debate. State preemption has generally been reserved for state laws that conflict with federal authorities. However, innovative technologies and changing consumer tastes have altered the way consumers bank. Financial products and services are delivered to diverse customers in various states, blurring the lines between what consumers have traditionally thought of as interstate and intrastate commerce.

The United States banking framework is a dual banking system in which national and state banks coexist and operate within their own spheres. National banks are chartered under federal law and generally subject to federal oversight; whereas state banks are subject to some federal oversight but also state-chartered and overseen.[140] This dual system was created by Congress's passage of the National Currency Act in 1863 and the National Bank Act in 1864. Those Acts provided banks with the opportunity to receive a federal charter to operate nationally, conditioned on the satisfaction of certain requirements.[141] Because national banks operate within states, federal preemption is used to eliminate confusion and overlap while reinforcing the overarching authority of the federal government to protect national institutions and enact

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[140] *See* Christine Daleiden, *Financial Reform for Consumers: An Overview of the Dodd-Frank Act and the Consumer Protection Bureau*, HAW. B.J. (April 2011).

[141] See Congressional Research Service, Federal Preemption in the Dual Banking System: An Overview and Issues for the 116th Congress, R45726 (2019).

laws intended to have a national impact. Naturally, federal preemption, which is essentially the supplanting of state legislation with federal regulation, causes tension and friction between federal actors and states.

The American system of competitive federalism provides a model of flexibility in constructing consumer- and competition-friendly financial services policy. Competitive federalism can do this in two ways: by creating an interstate common market through "vertical federalism," and by promoting competition and cooperation among states through the system of "horizontal federalism." Understanding the value of competitive federalism within the financial regulatory system, however, first requires understanding the role of federalism within the American constitutional system.

Two important purposes of the United States Constitution are: to protect individual liberty and to prevent political "factions" (what today are called "interest groups") from commandeering the power of government to advance their narrow special interests at the expense of the public interest. As James Madison commented in *Federalist* Number 51, "[i]t is of great importance in a republic, not only to guard the society against the oppression of its rulers; but to guard one part of the society against the injustice of the other part."[142] In order to accomplish these goals, the Constitution rests first on the consent of the governed but also constructs a system of "auxiliary precautions" such as the separation of powers, checks and balances, and federalism. These structural provisions of the Constitution reinforce each other – "[i]n the compound republic of America, the power surrendered by the people, is first divided between two distinct governments, and then the portion allotted to each subdivided among distinct and separate departments. Hence a double security arises to the rights of the people. The different governments will control each other; at the same time that each will be controlled by itself."

At the federal level, the tripartite system of separation of powers and checks and balances among the three branches of the federal government is designed to fragment and divide "factious majorities" who seek to use the power of the government to oppress minorities and whose designs are contrary to "justice and the general good." By selecting the members of each of the branches of the federal government and the bicameral legislature and giving them distinct but also overlapping powers, the Framers believed that the different branches would check each other, thereby preserving liberty and resisting the influence of factions as a by-product.

Federalism is designed, in part, to perform the same function of preserving liberty and frustrating interest-group influence by enabling the state and federal governments to check each other. As Madison observed in *Federalist* Number 45, a strong central government is "essential

[142] Federalist No. 51.

to guard [the people] against those violent and oppressive factions, which imbitter the blessings of liberty," when local interest groups operating at the state level seek advantage by protecting themselves from interstate competition. A primary rationale for the Constitution itself was to eliminate internal barriers to commerce and to allow the free flow of goods and services in interstate commerce, a right that was recognized for both buyers and sellers as essential to the welfare and prosperity of the nation.[143] Of particular concern was the centrifugal force of state governments, which often led to disunity and rivalry among the states as each sought to protect its own power and further the influence of entrenched, local special interests.[144] The Framers considered it imperative to protect the "commercial part of America" from these parochial interests that would attempt to close their markets to outsiders and protect themselves from competition.[145] The role of the federal government is to prevent this fragmentation and preserve the opportunity of sellers and buyers to transact in interstate markets undistorted by unnecessary and partial regulations.

Banking has inherently interstate characteristics with respect to payments, lending, and other financial services and has long been understood as an appropriate industry for regulation by the national government. Because of this reality, today's dual-banking system is starting to show some wear. As our national economy grows, so too does the need for greater federal oversight and presence in some areas. Innovation and the rise of technology, for example, have illuminated the redundancies of state involvement in the increasingly interstate and global activity of banking. Commerce is increasingly interstate due in large part to the internet. FinTechs, like peer-to-peer payment services, have capitalized on weaknesses in traditional methods of banking and digitally offer streamlined bank-like services using convenient payment platforms. These platforms generally work by accessing a consumer's traditional bank account, which allows these FinTechs to avoid regulations governing accepting and holding deposits. Nondepository institutions like these FinTechs have traditionally been chartered by state authorities, subjecting them to various state laws, including those imposing usury limits.[146]

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143 Federalist No. 11.

144 *See* Federalist No. 7 (expressing the concern that if left unchecked by the federal government, political incentives would lead to favoritism toward in-state interests resulting in "regulations of trade, by which particular states might endeavour to secure exclusive benefits to their own citizens").

145 *See* Michael S. Greve, The Upside-Down Constitution 19-22 (2012).

146 See Maria T. Vullo, The New York State Department of Financial Services Wins Big Against Office of the Comptroller of the Currency Over the Ability to Preempt the States in Chartering "Fintech" Non-Depository Companies (2019), available at https://wp.nyu.edu/compliance_enforcement/2019/05/08/the-new-york-state-department-of-financial-services-wins-big-against-office-of-the-comptroller-of-the-currency-over-the-ability-to-preempt-the-states-in-chartering-fintech-non-deposi/.

The growth of FinTech threatens the influence of two entrenched interest groups who have often resisted FinTech's disruptive influence: "(1) financial regulators; and (2) incumbents within the regulated industries."[147] Of course, these groups have always been ready to resist entry from innovative and vibrant competitors, from the opposition of traditional banks and alternative financial services providers to Walmart's efforts a decade ago to obtain an industrial loan corporation bank charter to FinTech innovators and Facebook's efforts to provide financial services.[148] State regulators stand to lose both power and billions of dollars in licensing fees.[149] As the chartering agency for banks, controversy has arisen over the OCC's plan to charter FinTechs. An OCC charter would largely remove states from the regulatory equation for national and international entities and require FinTechs to satisfy uniform national banking standards, including consumer protection laws. FinTech holds the potential to circumvent many of the barriers that today suppress competition and innovation to the detriment of consumers. At the same time, the creation of the Bureau created a muscular federal consumer protection regulator and enforcer that can protect consumers from unfair, deceptive, and abusive behavior by bad actors. Although state authorities play a vital and important role in enforcing consumer protection laws against local bad actors, with respect to national and global service providers, it is difficult to identify the benefits of regulation by 50 state authorities rather than a consistent and efficient regulatory framework.[150]

So far, the OCC's efforts to charter FinTech institutions have been stymied in the courts. Under the National Banking Act, as part of issuing a charter, the OCC is required to make a determination that an institution can "commence the business of banking."[151] Ruling on a lawsuit brought by state banking officials, a New York federal district court held that the "the business of banking unambiguously requires receiving deposits as an aspect of the business,"

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[147] Jeremy Kidd, *Fintech: Antitdote to Rent-Seeking?,* 93 CHICAGO-KENT L. REV. 165, 165 (2018).

[148] *See* Bernard Wysocki Jr., *How Broad Coalition Stymied Wal-Mart's Bid to Own a Bank,* Wall St. J. (Oct. 23, 2006) ("Wal-Mart's effort to open a bank has galvanized a broad coalition of opponents: large banks, small banks, the Federal Reserve, unions, grocers, real-estate agents and congressmen of both parties."), available at https://www.wsj.com/articles/SB116118495912296504.

[149] *See* Brian P. Brooks and Charles W. Calomiris, *Fintech Can Come out of the Shadows* (Sept. 9, 2020) ("In 2019, New York alone oversaw 113 state-licensed money transmitters, 18 nonbank lending companies, 92 sales finance companies, and other companies, some of which might qualify as national banks. Regulatory assessments alone earned Albany more than $100 million."), available at https://www.wsj.com/articles/fintech-can-come-out-of-the-shadows-11599693184.

[150] See id.

[151] *See* 12 U.S.C. 27; *See* Maria T. Vullo, *supra* note 146.

and therefore, did not include activities like those of nondepository FinTechs.[152] However, the ruling did not end the FinTech quest for chartering. The OCC issued its first full-service charter, rather than its controversial FinTech charter, to the first FinTech in 2020.[153] The charter was issued to Varo Bank, N.A., a full-service digital bank that offers checking and savings accounts through its mobile application.[154] Additionally, the Acting Comptroller announced that the OCC plans to introduce a payments charter that would preempt state payments licensing requirements.[155]

Given the rise and popularity of FinTechs, questions concerning where they fit in the banking ecosystem will continue. It may be time to consider creating a new chartering system to accommodate FinTech activities, lessen redundancies caused by state oversight, and bring FinTechs into the financial regulatory fold.

The current regulatory environment for non-depositories like FinTechs is an example of individual-state oversight (hereinafter referred to as "50-state oversight"). In a 50-state oversight regime, each state develops and enforces its own laws governing certain activities within that state. Where there is no federal law preemption, state laws apply to entities operating outside the state. Additional examples of 50-state oversight can be seen in data breach notification laws, which vary by state, and substantive data privacy laws such as the California Consumer Privacy Act. State data breach notification and data privacy laws regulate conduct as it applies to consumers located within certain states. Therefore, banks and non-banks generally must comply with the data breach and privacy laws in the states in which their consumers reside.[156]

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[152] *See Vullo v. Office of Comptroller of Currency,* 378 F. Supp. 3d 271, 292 (S.D.N.Y. 2019)(dismissing the OCC'S Motion to Dismiss); *Lacewell v. Office of Comptroller of Currency,* 2019 WL 6334895 (S.D.N.Y. Oct. 21, 2019) (issuing a stipulated final judgment in favor of the New York State Department of Financial Services and setting aside the OCC fintech regulation as to all applicants for a national banking charter that do not accept deposits).

[153] *See* https://www.occ.treas.gov/news-issuances/news-releases/2020/nr-occ-2020-99.html.

[154] *See* https://www.bloomberg.com/news/articles/2020-07-31/varo-becomes-first-consumer-fintech-to-land-a-national-charter.

[155] *See* Judith E. Rinearson and Mehreen Ahmed, *It's Ba-ack! OCC Planning A New Fintech Charter: "Payments Charter 1.0"*, NATIONAL LAW REVIEW, Volume X, Number 188 (2020), available at https://www.natlawreview.com/article/it-s-ba-ack-occ-planning-new-fintech-charter-payments-charter-10.

[156] Of note, the Gramm-Leach-Bliley Act (the "GLBA") is a federal data privacy law that applies to financial institutions, but Congress chose not to preempt all state privacy laws when it passed the law. The GLBA does not preempt state laws as long as they are not inconsistent with GLBA requirements. States may also enact laws that are more stringent than the GLBA. *See* 15 U.S.C. 6807(a).

The Taskforce believes the regulatory regime for credit cards that evolved in the aftermath of the Supreme Court's decision in *Marquette* provides an excellent model for FinTech regulation. [157] As discussed in Chapter 10, that regulatory regime empowered consumers to choose their preferred regulatory framework for credit cards. In that case, Marquette National Bank sued First Omaha, a national bank headquartered in Nebraska, alleging that its credit card interest rates violated Minnesota-state usury laws. The Supreme Court found that First Omaha could charge Minnesota customers interest rates permitted in First Omaha's home state of Nebraska. This was because the National Bank Act allowed national banks to charge interest rates based on the laws of the state in which the bank was located. Under the specific facts of the case, the Supreme Court's ruling essentially created two different credit card options: the "Minnesota card" model under which the consumer was "protected" by a maximum state usury ceiling of 12 percent annual percentage rate (APR) but also had to pay an annual fee of $10 or $15 to have a card; or the "Nebraska card" which had a higher usury ceiling of 18 percent APR but no annual fee (the "*Marquette* approach"). As noted in the oral argument of the case, residents of Minnesota were flocking to the "Nebraska card," but there was minimal traffic in the other direction, which suggested that the card with more flexible pricing terms was preferred by consumers. [158] By enabling consumers to avail themselves of a different state's regulatory rules regardless of their state of residence, there was a competition among the different state's regulatory rules and the way those rules influenced the terms and availability of credit cards. Moreover, as admitted in the oral argument by Minnesota's attorney general, one of the major purposes of the state's law was to protect in-state banks from competition, even if that resulted in Minnesotans paying higher prices and gaining less access to credit than they otherwise would.

A regime similar to the *Marquette* approach could be adopted on a state level through interstate reciprocity agreements or the enactment of federal laws with provisions similar to the home-state rule provision in the National Bank Act. Such a regime would eliminate redundancies caused by 50-state oversight and increase competition among states to offer chartering options that fit the needs of financial service companies and their consumers. The state of Delaware's success with attracting corporations is illustrative of this potential. Delaware has established itself as the "Bergdorf Goodman or Tiffany" [159] among states hoping to woo businesses and encourage incorporation within their borders. Delaware has done this by enacting laws that offer corporations flexible options for running their businesses, which are supported by a

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[157] See Marquette National Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299 (1978).

[158] *See* discussion in chapter 10; *see also* NCCF Report, *supra* note 2, at 207.

[159] *See* https://corplaw.delaware.gov/why-businesses-choose-delaware/.

business-savvy judicial system. States could replicate Delaware's success on the banking front by employing the same methodology.

Competitive federalism recognizes the opportunity for state governments to experiment with their own policies and to cooperate to adopt policies that break down barriers to interstate competition, advance the goal of a more robust internal free market, and increase consumer choice by making it easier for consumers to shop across state lines. The federal government can also play a role in facilitating these cooperative arrangements. In this vein, the CFPB's announcement in September 2019 of the creation of the "American Consumer Financial Innovation Network" (ACFIN) provides a model for an additional way forward.[160] Initially launched with seven participating states, ACFIN establishes a mechanism for states to harmonize their rules regarding FinTech and to create a system of reciprocal licensing with member states, thereby creating a sort of internal free trade zone among the member states. As of November 2019, the number of states participating in ACFIN had grown to 13.

The NCCF called out for special criticism the "anachronistic notions" of some state legislatures with respect to the maintenance of laws such as usury ceilings and barriers to entry that resulted in the citizens of their state "suffer[ing] deprivations of credit afforded others of equal standing" who simply happened to reside a state with more enlightened policies regarding the regulation of credit.[161] The NCCF "urge[d] as its first choice the adoption of state laws designed both to assure fair treatment of all consumers and to give all credit grantors equal opportunity to compete." But it also noted, "Failing this, the Commission's second choice is to urge Federal legislation to accomplish this goal."

Not all state laws are "anachronistic," of course, and state authorities play an essential role in protecting consumers, especially in enforcement against local bad actors. Within the American economy, commentators have argued that consumers are protected by a three-legged stool of consumer protection with market competition, common law institutions of contracts, tort and property and consumer protection law, comprising the three legs of the stool. But others have argued that the stool is actually a sturdy table supported by a fourth leg – jurisdictional competition between regulators, which has been the most impactful in the realm of financial regulation.[162] Jurisdictional competition has allowed regulators to learn from their own successes and failures and those of other regulators. In the financial sector, jurisdictional

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[160] *See* Consumer Financial Protection Bureau, *CFPB and State Regulators Launch American Consumer Financial Innovation Network* (Sept. 10, 2019), available at https://www.consumerfinance.gov/about-us/newsroom/bureau-state-regulators-launch-american-consumer-financial-innovation-network/.

[161] NCCF Report, *supra* note 2.

[162] *See* G. Marcus Cole commentary, available at https://www.consumerfinance.gov/about-us/events/archive-past-events/taskforce-public-hearing/

competition among states, between the federal government and states, and within the federal government creates a feedback loop that affords each group an opportunity to further hone its understanding of the financial market and the regulations it enacts to protect it.[163]

The Taskforce shares the NCCF's concern about the adverse effects on consumers, especially traditionally excluded consumers, and competitors from "anachronistic" state laws such as usury ceilings and regulatory-created barriers to entry. The Taskforce does not advocate for national preemption of state laws. Instead, we share the NCCF's admonition about the adverse effects of certain state laws and urge the states to evaluate their existing usury ceilings, barriers to entry, and other laws that limit access to credit and reduce competition, especially competition by out-of-state providers. The Taskforce also has the benefit of the 40-year experiment with the *Marquette* approach for credit card regulation, which the NCCF did not. As we will discuss in greater detail below, the Dodd-Frank Act carved a path for states to act in the financial services landscape. But as more and more financial services become multistate, states should continually consider their value-add in the modern financial marketplace. The view of the Taskforce is that the approach of dual federal chartering and home-state regulation strikes an appropriate and effective balance between the powers of federal and state governments while facilitating consumer choice, access, and competition.

The preemption regime in the Dodd-Frank Act attempts to a strike a similar balance between recognizing a state's right to protect its consumers, on the one hand, and standardizing the application of national law while creating a floor for consumer protection standards, on the other. It redrew the boundaries of the preemption standard, narrowing the scope of federal government preemption of state laws and enforcement powers and increasing the permissible scope of authority of state regulators. It also attempts to clarify the state of current preemption standards for banking laws. At the outset, the Supreme Court has recognized three bases for preemption: 1) express or implied preemption; 2) field or implied preemption; and 3) conflict preemption.[164] The Dodd-Frank Act embraces a conflict preemption standard.[165] Conflict preemption generally applies when there is an "irreconcilable conflict" between federal and state law, meaning it would be virtually impossible to comply with both.[166] Under the Dodd-Frank Act, a state law is not preempted unless it is "inconsistent" or in conflict with the Act.[167] The law

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163 *See id.*

164 See Baptista v. JPMorgan Chase Bank, N.A., 640 F.3d 1194 at 1197(2011).

165 *See* Section 1041(a)(1) of the Dodd-Frank Act.

166 *See* Dori K. Bailey, *Preemption Principles: Weighing the Impact of Dodd-Frank,* BANKING & FIN. SERVICES POL'Y REP. at 2 (July 2015).

167 *See* Section 1041(a)(2) of the Dodd-Frank Act.

specifies that a state affording consumers more protection than the Dodd-Frank Act confers does not constitute a conflict.[168]

The Dodd-Frank Act provides that state consumer financial laws governing national banks will be preempted in only one of three instances: 1) the state law has a discriminatory effect on national banks; 2) a court or the OCC determines the law "prevents or significantly interferes" with a national bank's exercise of its powers; or 3) the law is preempted by another federal law. The first scenario addresses instances of overt and latent discrimination. A state law that discriminates against a national bank might be one in which the national bank is required to pay a fee that state banks are not. But it might also encompass a situation where a national bank is required to pay both a national and state fee; whereas a state bank might only be required to pay state fees.[169]

The Dodd-Frank Act's second preemption scenario codifies the Court's ruling in *Barnett Bank of Marion County, N.A. v. Nelson*.[170] In *Barnett*, the state of Florida attempted to prohibit a bank from selling insurance although it was permitted to do so under federal law. The Court found that states cannot forbid or significantly impair powers Congress has granted to national banks.[171] A state law that impairs a national bank's power to conduct an activity that is integral to its business would likely "significantly impair" powers granted to a national bank.[172] The facts in *Baptista v. JPMorgan Chase Bank, N.A.* illustrate this concept. In another Florida case, the state attempted to prohibit a national bank from imposing check-cashing fees. The court found that Florida's law created a "clear conflict" between the Dodd-Frank Act and the Bank's federal authorization and, thus, was preempted.[173] *Baptista* also highlights that a state's good intentions when enacting a conflicting law is not relevant to the court's determination of whether a state law is preempted.[174] Along the same lines, the Dodd-Frank Act also reinforces that Dodd-Frank's limits on preemption shall not be construed as altering or otherwise affect the established rule under *Marquette* that permits national banks to charge interest at the rate allowed by the state in which it is located..[175]

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168 *See id.*

169 *See* Dori K. Bailey, *supra* note 166.

170 *See* Section 1044 of the Dodd-Frank Act.

171 See Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25 (1996).

172 *See* Dori K. Bailey, *supra* note 166.

173 *See Baptista*, 640 F.3d 1194.

174 *See* Dori K. Bailey, *supra* note 166.

175 *See* Section 1044 of the Dodd-Frank Act.

On the other end of the spectrum, the Dodd-Frank Act bolsters states' rights by clarifying that state laws apply to bank subsidiaries. Prior to Act, the Supreme Court in the *Watters* case established the preemption standard as to subsidiaries of national banks.[176] In *Watters*, the Court considered whether a state could impose licensing, visitorial and reporting requirements on a national bank subsidiary. The Court found that because federal law authorized national banks to conduct activities through their subsidiaries, states could not impair or impede this right by imposing additional requirements on subsidiaries to operate in a state. The Court also found that a state could not impose its laws on a bank domiciled outside the state. The Dodd-Frank Act overturned the *Watters* decision and clarified that national bank subsidiaries and affiliates are subject to state consumer financial laws (unless the subsidiary or affiliate is a national bank).[177] It also included a savings clause clarifying that the National Bank Act did not preempt the applicability of other state law to subsidiaries and affiliates.[178]

Apart from national banks and federal savings associations, the Dodd-Frank Act also provides state attorneys general, or a state regulatory agency depending on the circumstance, with the authority to bring an action for violations of the CFPA or rules issued thereunder.[179] Additionally, the law authorizes states to enforce rules promulgated pursuant to the CFPA against a national bank or federal savings association.[180] But states may not enforce the CFPA, itself, against national banks.[181]

State enforcement of federal consumer financial law creates additional regulatory overlap in the financial system. As with federal stakeholders, the Bureau and states are generally required to coordinate activities with one another. Here too, the Bureau employs the use of MOUs to establish procedures that will govern their working relationship. These memorandums may be executed to account for coordination on an ongoing basis or to develop a strategy to coordinate on a specific investigation.

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176 See Watters v. Wachoiva Bank, N.A., 551 U.S. 1 (2007).

177 *See* Section 1044(e) of the Dodd-Frank Act.

178 *See id.* at Section 1044(b)(2); 12 U.S.C. 25(b)(b)(2). Of note, the savings clause also states that the Federal Reserve Act does not preempt the applicability of state law with respect to subsidiaries and affiliates.

179 *See id.* at Section 1042(a)(1).

180 *See id.* at Section 1042(a).

181 *See id.* at Section 1042(a)(2).

13.4 Regulatory Modernization

The Bureau's Director assembled the Taskforce to assess the current state of the U.S. financial regulatory system and imagine a way forward. As is evident from this Chapter's description of the various facets of this system, it has successes, benefits, drawbacks, and inefficiencies. Among the successes and benefits are the ability to draw from the financial regulators' respective areas of expertise and the system's flexibility in the face of crises. The drawbacks and inefficiencies ripe for improvement include the jurisdictional status of auto dealers and the uncertainties resulting from the *Seila Law* decision.

13.5 Regulatory Effectiveness

The federal financial regulatory regime is a dizzying array of federal and state stakeholders, jurisdictional mishmash, and subsurface tension. But each actor has a role to play. The fact that their roles overlap does not diminish the importance of each. Multiple financial services regulators result in multiple opportunities to prevent misconduct and consumer harm. The prudential regulators have developed expertise with handling matters germane entities within their jurisdiction; whereas the Bureau has developed expertise with financial consumer protection matters.

One of the benefits of shared jurisdiction is the ability to draw from skillsets and expertise. The Dodd-Frank Act established the Bureau as the preeminent expert in consumer financial protection. Congress's decision to create an agency primarily concerned with consumer protection reflects the high priority the financial system places on consumer confidence and safety. The Great Depression, the Great Recession, the global COVID-19 pandemic, and countless other catastrophic events have spotlighted the essential role consumers play in the health and stability of the U.S. financial market and the global economy. They have also highlighted the vital role finances play in consumers' overall quality of life. While each prudential regulator has a view into the intersection of safety and soundness and consumer protection as to the entities they each regulate, the Bureau has a broad view and expertise in consumer protection across all consumer finance markets. As such, regulators afford the Bureau deference in this area on matters of consumer protection.

The same can be said of the FTC with respect to data breaches at nondepository institutions. The FTC has developed a skillset for adeptly investigating and prosecuting poor practices that lead to data breaches. The Bureau should rely on this skillset rather than recreating the FTC's well-established expertise. Although establishing formal lines of authority among regulators is not yet necessary, the Bureau should consider negotiating an MOU with the relevant financial regulators stating that the Bureau is the primary consumer compliance examiner and recognizing the FTC as the nation's data breach specialist.

Federal regulators and prudential regulators should continue to coordinate their activities to eliminate redundancies and take advantage of the benefits of their close working relationships. Opportunities for greater cooperation include increasing the number of joint examinations of supervised entities; and working together to proactively develop a comprehensive incident response plan across the financial market to combat consumer harms related to declared emergencies and other catastrophic or unforeseen events such as the COVID-19 pandemic.

States also serve an important role in the consumer financial law regime. But the value of state actors operating in an increasingly interstate and global financial environment is decreasing. The growth of the national economy has led to both a greater need and greater efficiency case for a federal presence, and thus, preemption. Additionally, the cost of federalism grows with federal dominance. The Bureau is illustrative of this reality. The argument for preemption is stronger in a world where the Bureau exists given it is well-designed to supervise national providers of financial products or services. Congress should continue to consider whether the states' expenditure of resources to regulate these entities makes sense given states' limited view into a national provider's overall business or national impact.

On the other hand, state oversight has advantages. States have a legitimate interest in protecting their consumers, and they are uniquely positioned to understand the needs of consumers in their respective markets. As the nation's "laboratories,"[182] state oversight offers a ground-level view of issues that may surface on a national level. In this way, states act as a first-warning system and provide federal regulators with opportunities to course-correct and prevent or mitigate consumer harm on a national scale. Enacting the *Marquette* approach would maintain state presence in the consumer protection space while eliminating the redundancies created by 50-state oversight. Some critics argue the *Marquette* approach could result in businesses migrating to states with the least consumer protections and operational restrictions.[183] On the

[182] *See New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the nation. It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country. This Court has the power to prevent an experiment. We may strike down the statute which embodies it on the ground that, in our opinion, the measure is arbitrary, capricious, or unreasonable. . . . But, in the exercise of this high power, we must be ever on our guard, lest we erect our prejudices into legal principles. If we would guide by the light of reason, we must let our minds be bold.")

[183] *See e.g.* Robert R. Drury, *The Regulation and Recognition of Foreign Corporations: Responses to the "Delaware Syndrome"*, THE CAMBRIDGE LAW JOURNAL, vol. 57, no. 1, 1998, pp. 165–94. (1998) (Describing the phenomenon in which corporations incorporate in Delaware given the perception that its laws favoring corporations),

other hand, many have argued that in the field of corporate law, competition among the states pushes toward optimal laws.[184] Moreover, however well-grounded criticisms of the *Marquette* approach may be, they are far weaker today with the Bureau as a forceful national cop on the beat. Experience with the *Marquette* approach suggests some of these criticisms are unfounded and are outweighed by the benefits to consumers.

Over the course of 2020's turbulent year, what has become more evident is that our financial system's flexibility has allowed the nation to withstand headwinds resulting from shared crises. Financial regulators, including the Bureau, have issued guidance and provided support materials to ease the concerns of consumers and industry. Just as the country prepared to quarantine due to the pandemic, the federal financial regulators and the Conference of State Bank Supervisors issued a joint statement encouraging financial services providers to work with consumers affected by the pandemic.[185] In April, the FRB, the FDIC, and the OCC issued an interim final rule extending the time period to conduct real-estate appraisals and evaluations to afford institutions the ability to provide financing to creditworthy borrowers quickly.[186] The Federal Housing Finance Agency also implemented loan origination flexibilities which included, among other things, an expansion of requirements intended to make remote closings more efficient.[187] These actions only reflect a handful of the actions financial regulators have taken to protect the financial market and consumers.

Financial regulators cobbled together a response to these challenges using their ingenuity, alacrity, and the discretion afforded to them to enforce laws and regulations and suspend those that may have negative consequences in the midst of crises. While financial regulators' response to the pandemic has been extraordinary, future crises are inevitable. Events like the pandemic have highlighted the need for flexibility in the regulatory system to deal with unanticipated shocks. Financial regulation traditionally has been highly prescriptive in its rule structure, an

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available at www.jstor.org/stable/4508425; William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* The Yale Law Journal, vol. 83, no. 4, pp. 663-705 (1974)(arguing that corporations incorporate in Delaware due to favorable tax, trust, and corporation laws resulting in the deterioration of corporation standards), available at https://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=6235&context=ylj)

[184] Roberta Romoano, *The Genius of American Corporate Law,* American Enterprise Institute (1993), available at https://EconPapers.repec.org/RePEc:aei:rpbook:53342.

[185] *See* Joint Statement, available at https://www.ncua.gov/newsroom/press-release/2020/agencies-encourage-financial-institutions-meet-financial-needs-customers-and-members-affected.

[186] *See* Interagency Statement on Appraisals and Evaluations for Real Estate Related Financial Transactions Affected by the Coronavirus, available at https://files.consumerfinance.gov/f/documents/cfpb_interagency-statement_real-estate-transactions-covid-19.pdf.

[187] *See* Federal Housing Finance Agency News Release, available at https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Extends-COVID-Related-Loan-Processing-Flexibilities-for-Fannie-Mae-and-Freddie-Mac-Customers-Through-August.aspx.

approach that creates certainty and predictability for consumers and providers but can stifle change and adaptability, especially in crises. But financial regulators' ability to react quickly and decisively in an emergency is a product of legislation that affords them the discretion to do so when circumstances appropriate such a response. Therefore, it is the view of the Taskforce that Congress should create a framework that cements the authority of regulators to use their discretion in the event of an emergency and provides regulators with a greater set of tools to channel that discretion.

A future emergency response framework should include automatic policy responses (or automatic stabilizers) that are triggered by the President's declaration of an emergency. Automatic responses will allow regulators to swiftly react to crises rather than spending valuable time crafting *ad hoc* solutions. The framework might also provide federal regulators with authority to suspend state regulations that impede federal efforts to respond to emergencies and stabilize the economy.

13.6 Opportunities for Modernization and Greater Coherence

It is incumbent on financial regulators and Congress to continue to find ways to make the financial regulatory system more agile and responsive to the dynamic needs of firms and consumers. Improving the system calls us to take a clear-eyed look at the way the world has changed and imagine a financial system that serves our present and future needs. With this vision, the Taskforce considers the following to be opportunities to improve the federal financial regulatory landscape.

13.6.1 Auto Dealer Authority

The high cost of cars means consumers often finance the purchase through credit. As of 2019, the auto loan market was the third largest market behind mortgages and student loans. According to a 2018 study by New York's Federal Reserve Bank, approximately 45 percent of American consumers had an auto loan or auto loan debt.[188] Consumer demand for used cars has dramatically increased along with the cost of procuring one since the global pandemic due to

[188] *See* Congressional Research Service, *The Automobile Lending Market and Policy Issues,* IF11192 (April 2019), available at https://fas.org/sgp/crs/misc/IF11192.pdf.

reduced auto production and concerns about close-quarters on public transportation.[189] Furthermore, in an indirect lending relationship, auto dealers receive compensation for their referrals of consumer credit to lending institutions. This markup is based on the difference between the lender's interest rate and the rate charged to a consumer.[190] So, auto dealers' profits are directly linked to the cost to consumers. In some instances, regulators have alleged and studies have suggested that dealers imposed markups that have resulted in consumers of color, e.g., Blacks, Hispanics, and Asian and Pacific Islanders, paying significantly higher dealer markups unrelated to their ability to repay the loan.[191] In perhaps one of the most flagrant instances of discrimination, a dealership in the New York's Bronx borough allegedly instructed its employees to charge higher prices to these consumers specifically.[192] This issue has led some at the FTC to argue for exercising its authority under the Dodd-Frank Act to regulate dealer markups to prevent abuses and discrimination.[193]

Currently, auto financing institutions are overseen by the Bureau, and auto dealers are overseen by the FTC, but shared authority between the Bureau and the FTC over auto dealers is appropriate. First, the Dodd-Frank Act conferred to the Bureau supervisory authority over nondepositories in markets for payday loans, residential mortgages, and private education lending in addition to nondepositories that the Bureau determines pose a risk to consumers and larger participants in markets for consumer financial products or services that the Bureau determines by rulemaking. Additionally, the FTC's current jurisdiction includes auto sales, and the Bureau's includes auto financing. As facilitators of consumer credit, auto dealers are

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189 *See e.g.* https://www.npr.org/2020/10/28/927971920/a-pandemic-sticker-shock-used-car-prices-are-through-the-roof.

190 *See CRS Report* IF11192, *supra* note 188.

191 *See* e.g. Complaint at 26, Federal Trade Commission v. Liberty Chevrolet Inc., et al., (S.D.N.Y. 2020) (No. 20-CV-3945), https://www.ftc.gov/system/files/documents/cases/bronx_honda_complaint_0.pdf); Bureau Press Release announcing settlement with American Honda Finance Corporation, available at https://www.consumerfinance.gov/about-us/newsroom/cfpb-and-doj-reach-resolution-with-honda-to-address-discriminatory-auto-loan-pricing/. *See generally* Jason Hernandez, Loan Discrimination At the Auto Dealership: Current Cases, Strategies and the Case For Intervention By Attorneys General, Columbia University, available at https://web.law.columbia.edu/sites/default/files/microsites/careerservices/Loan%20Discrimination%20At%20The%20Auto%20Dealership.pdf; *Examining Discrimination in the Automobile Loan and Insurance Industries: Hearing Before the H. Comm. on Fin. Servs. Subcomm. on Oversight and Investigations* (May 1, 2019) (testimony of Kristen Clarke), available at https://lawyerscommittee.org/wp-content/uploads/2019/04/Discrimination-in-Auto-Lending-Statement-of-Kristen-Clarke-FINAL.pdf.

192 *See* Complaint at 26, Federal Trade Commission v. Liberty Chevrolet Inc., et al., (S.D.N.Y. 2020) (No. 20-CV-3945).

193 *See* Statement of Commissioner Rebecca Kelly Slaughter *in the Matter of Liberty Chevrolet, Inc. d/b/a Bronx Honda Commission File No. 1623238, (May 2020),* available at *https://www.ftc.gov/system/files/documents/public_statements/1576006/bronx_honda_2020-5-27_bx_honda_rks_concurrence_for_publication.pdf.*

inextricably linked to the current auto lending market. Thus, the FTC and the Bureau should share oversight duties to fully cover the scope of activities in the auto lending market.

13.7 Cost-Benefit and Bureau Activity Analysis

Tradeoffs are inevitable in life, markets, and regulation. For example, as has been stressed throughout this report, policymakers can either have price controls on consumer credit or broad inclusion, but they cannot have both. Stricter usury ceilings can suppress prices for those who can get credit but will reduce access to credit for those who are priced out of the market, forcing them to rely on more-expensive and less-desired products. All regulation, therefore, has both benefits and costs, and effective regulation is that for which the overall benefits are greater than the costs.

Cost-benefit analysis (CBA) is simply an accounting of the positive and negative impacts of the choices available when making a decision. As such, CBA is ubiquitous in everyday life. In fact, is difficult to imagine a careful decision without a consideration of both the positive and negative impacts the various choices would have on our lives. These decisions can be as consequential and complex as choosing where to live, or as simple as choosing a cereal at a grocery store. The former decision involves considering housing costs, size, and amenities; transportation options and costs; as well as geographical amenities of the community like schools, restaurants, and recreation. Housing choices will vary along these qualities, and making a decision involves weighing tradeoffs associated with each choice. Likewise, choosing a cereal may involve considerations of nutrition, price, brand-recognition, and even box size may play a role for storage-space constrained consumers.

These two examples are instructive. For instance, the decision between cereals is minor and unlikely to have large consequences for a consumer's lifetime well-being. Of course, the vitamins and minerals offered by the cereal options will impact the consumer's health, but the incremental contribution of a single cereal decision to lifetime well-being is very small. Because of this, some consumers may not spend much time deciding – and may choose based on the artwork on the box or some other trivial consideration. But for others, some care will go into the decision and those thoughts will invariably be some form of weighing the advantages and disadvantages of each option.

On the other hand, housing decisions are highly consequential choices that impact household wealth and happiness; the amount of time spent with their family; and even the opportunities available to children. Prospective homebuyers might consider making a list of the advantages and disadvantages of their housing options to help them make their choice. Some homebuyers may even research housing price growth in the various neighborhoods to approximate the impact of their choices on their net worth. Still, others may make a spreadsheet to estimate the amount of equity they may have in their home after five or 10 years. Surely, many people evaluate the monthly cost of the home and how much of their budget would remain for other pursuits. The particularly enterprising buyers may even factor in the impact of their decision on their children's future earnings.[194] Very few people are likely to think that these analyses are unwarranted, irresponsible, or overly time-consuming for such a consequential decision.

These examples highlight that CBA is a common tool people use to make decisions, and that the level of care and analysis we do to inform our decisions varies by how important the decision is. Not only does this explain why we may do more analysis on a housing decision than a cereal decision, it is why corporations have entire finance departments to evaluate the merits of proposed projects. CBA is deployed in the private sector to inform decisions on projects ranging from capital investment to new product offerings. Government regulators' use of cost-benefit analysis as a tool to assist in making and supporting decisions that impact *every* mortgage or *all* firms in an industry reflects the prudence and care we put into decisions we make in our personal and professional lives. The formal cost-benefit analysis done by government agencies in support of regulatory decisions mimics these decision-making processes that we all use every day. Furthermore, formal cost-benefit analysis lends credibility, accountability, and transparency to decisions that are often made by career or appointed civil servants that involve how we allocate our society's valuable and scarce resources.

History of Cost-Benefit Analysis in Agency Rulemaking

CBA of the informal variety referenced in the previous section has likely been a part of human decision-making for a very long time. For instance, Boardman et al. open their textbook on CBA with an extended quotation from a letter written by Benjamin Franklin to Joseph Priestly where Franklin describes his approach to making important decisions by making a list of pros and cons, and then striking through those pros and cons he believes cancel out.[195] Franklin says that

[194] Raj Chetty, Nathaniel Hendren, and Lawrence Katz, *The Effects of Exposure to Better Neighborhoods on Children: New Evidence from the Moving to Opportunity Project*, AMERICAN ECONOMIC REVIEW, 106 (4) (2016), available at https://scholar.harvard.edu/hendren/publications/effects-exposure-better-neighborhoods-children-new-evidence-moving-opportunity.

[195] BOARDMAN, A. E., GREENBERG, D. H., VINING, A. R., & WEIMER, D. L. COST-BENEFIT ANALYSIS; CONCEPTS AND PRACTICE (2018).

the reason for this is that each of the "pro and con are not present of mind at the same time" and he says of the results, "I think I can judge better, and am less liable to make a rash step …"[196]

The formal variety of CBA that has become ubiquitous at executive agencies and has been a cornerstone in regulatory decisions spanning four decades and six Presidential administrations began to take shape in the 1930s. The Flood Control Act of 1936 required the Army Corps of Engineers to conduct CBAs on planned flood and harbor projects. This requirement resulted in the further refinement of the practice and principles of cost-benefit analysis in water resource decisions in the following decades, ultimately culminating in the Bureau of the Budget's 1952 Circular A-47 outlining the principles of CBA in guidance for agencies making water resource decisions.[197]

While CBA in on-budget resource decisions began to flourish in the 1930s and 1940s, nascent obligations resembling CBA began to appear in the regulatory space in the 1970s.[198] The first real obligation to conduct CBA in support of regulation as we know it today was established by President Reagan in 1981 with his Executive Order (EO) 12291, which required that agencies conduct a regulatory impact analysis of all major regulations, including an assessment of benefits, costs, and net benefits. The order also established centralized review and coordination of agency rulemaking and associated regulatory impact analyses within the OMB.

In part due to procedural criticisms of OMB review, President Clinton replaced EO 12291 with EO 12866, which reaffirmed the practice and principles of regulatory CBA, but limited OMB review to "significant" regulations.[199] This reform substantially reduced the number of rules that OMB reviewed.[200] Nevertheless, EO 12866 has proven to have staying power, as every President since has reaffirmed its principles and the practice of CBA – and it remains in force to this date.

Between 1993 and today, many memos, circulars, and orders have been issued to enhance and further solidify the practice of conducting CBA in the rulemaking process for executive Agencies. OMB Circular A-4 was published in 2003 providing technical guidance for agencies on matters

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[196] Letter from Benjamin Franklin to Joseph Priestly (1772) in Boardman et. al, *supra* note 195.

[197] For more information about the development of CBA in water resource decisions see Hufschmidt, M., *Benefit-Cost Analysis: 1933-1985*, available at https://opensiuc.lib.siu.edu/cgi/viewcontent.cgi?article=1196&context=jcwre

[198] Stuart Shapiro, *The Evolution of Cost–Benefit Analysis in US Regulatory Decision-making* (2011), available at https://pdfs.semanticscholar.org/d06b/2183437547e4b32614e7980257130169e685.pdf?_ga=2.267257879.1026816008.1596222479-1635246547.1596222479

[199] Exec. Order No. 12,866 (1993), available at https://www.archives.gov/files/federal-register/executive-orders/pdf/12866.pdf.

[200] Data from www.reginfo.gov, comparing the period Feb. 19, 1981 through Sept. 30 1993, with the period Oct. 1, 1993 through Sept. 30, 2017.

ranging from valuing reductions in mortality risks to the discount rates agencies should use for future benefits and costs to reflect social time preference.[201] President Obama issued EO 13563 in 2011, which required agencies to conduct retrospective analyses of prior rulemakings and remove outdated regulations. EO 13563 also built upon 12866's principles of considering impacts that are difficult to quantify by adding human dignity and fairness considerations, in addition to equity and potential distributive impacts of regulation.[202] President Trump's EO 13771 reaffirmed both EOs 13563 and 12866 and introduced an additional constraint on regulatory decision-making in the form of a regulatory cost allowance for every executive regulator.[203]

While CBA has been a cornerstone of regulatory decision-making at executive agencies for decades, its development at independent agencies has been mixed. An Administrative Conference of the United States (ACUS) Report summarized the statutory authorities of independent regulatory agencies and found that three were statutorily required to do cost-benefit analysis (CPSC, FRB for electronic funds transfer rules, and FTC), six are obligated to adhere to a weaker standard of "considering" costs and benefits (CFPB, SEC, CFTC, the FRB, OCC, and FDIC), and three have no requirements at all (Nuclear Regulatory Commission (NRC), Federal Energy Regulatory Commission (FERC), and Federal Communications Commission (FCC).[204]

Thus, the ACUS Report identifies CFPB in the weaker standard category of having a requirement to merely consider costs and benefits. The specific language of the requirement to consider the costs and benefits of their rules is from Section 1022(b)(2) of the Dodd-Frank Act:

In prescribing a rule under the Federal consumer financial laws—(A) the Bureau shall consider—(i) the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule; and (ii) the impact of proposed rules on covered persons, as described in section 1026, and the impact on consumers in rural areas.

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[201] OMB's M-03-21 Circular A-4 (2003) "Regulatory Analysis" can be accessed at https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/circulars/A4/a-4.pdf.

[202] Exec. Order No. 13,563 (2011), available at https://obamawhitehouse.archives.gov/the-press-office/2011/01/18/executive-order-13563-improving-regulation-and-regulatory-review

[203] Exec. Order No. 13,771 (2017), available at https://www.govinfo.gov/content/pkg/FR-2017-02-03/pdf/2017-02451.pdf

[204] Admin. Conf. of the U.S., Recommendation 2013-2, *Benefit-Cost Analysis at Independent Regulatory Agencies*, 78 Fed. Reg. 41,355 (July 10, 2013). Pg. 56, available at https://www.acus.gov/sites/default/files/documents/Copeland%20Final%20BCA%20Report%204-30-13.pdf.

Even though the CFPB's statutory requirements adhere to a weaker standard, as identified by ACUS, CFPB does not appear to be constrained to adhere to a lower standard. Instead, the CFPB could conduct complete regulatory CBAs that executive agencies adhere to. To determine the extent of CFPB's implementation of the statutory requirements, this section of the Taskforce's report provides a review of the CFPB implementation of these requirements and compares them with best practices the Taskforce identified in the section below.

Purpose of Cost-Benefit Analysis

A formal cost-benefit analysis is a structured approach to organizing the assumptions, information, and knowledge about the advantages and disadvantages of competing approaches to solving a problem. A typical CBA begins with an analysis of the nature and extent of the problem the regulator is trying to solve. Then the analysis proceeds to identify and analyze alternative approaches to solving the problem while also disclosing the information and methods used. Finally, the analysis summarizes the benefits and costs of each alternative and recommends a preferred approach.

The purpose of using CBA in regulatory analysis are as follows:

1. **Improve regulatory decisions:** First and foremost, a rigorous and structured approach to analyzing a problem and evaluating the tradeoffs associated with alternative approaches to solving a problem can reveal new information or present information in valuable new ways that leads to better regulatory decisions.

2. **Transparency:** The process of conducting a CBA to support a regulatory decision enhances transparency by forcing agencies to identify the sources of information and the methodologies used to analyze a problem and the solutions.

3. **Accountability and credibility:** Federal regulators have numerous stakeholders in the actions they take, including Congress, the President, regulated parties, taxpayers, and voters. Agencies are often given broad authorities by Congress, which often prefers to defer certain regulatory decisions to professionals in agencies. The aforementioned transparency provided by a rigorous CBA also informs those parties that hold an agency accountable of the trade-offs involved in a regulatory decision.

Thus, the purpose of CBA in regulatory analysis is generally a good-governance one. It is not intended to constrain the information to be considered, as some critics suggest. Nor is it intended to reduce the options available to regulatory decision-makers to only those that perform best in the analysis. The true purpose is to better inform decisions, as well as the public, on the advantages and disadvantages of the options available.

Principles and Best Practices of Cost-Benefit Analysis

Identification and implementation of a set of principles or best practices of CBA is a common feature in regulatory programs. In the United States, EO 12866 and OMB Circular A-4 provide guidance on best practices in regulatory CBA. Similar guidance exists in other countries as well.[205] In some ways, the establishment of principles and best practices is itself a best practice. It standardizes important elements and establishes a set of policies to hold agencies accountable to. The accountability function can be enhanced by an oversight body that reviews regulatory analyses for consistency with the best practices.

To identify principles and best practices of CBA, the Taskforce reviewed several authorities on cost-benefit analysis – in addition to relying on expertise among the Taskforce members and staff. First, and perhaps most important, the Taskforce reviewed OMB Circular A-4, which provides technical guidance to the heads of executive agencies on regulatory analysis. Second, we reviewed another OMB resource - OMB Circular A-94, "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs."[206] Third, we reviewed the United Kingdom's Regulatory Policy Committee (RPC) guidance on regulatory impact assessments.[207] Fourth, we reviewed the best practices for CBA identified in the ACUS Recommendation 2013-2, *Benefit-Cost Analysis at Independent Regulatory Agencies*.[208] Fifth, we studied the Organisation of Economic Cooperation and Development's (OECD) 2012 *Recommendation of the Council of Regulatory Policy and Governance*.[209] Lastly, the Taskforce consulted *Cost Benefit Analysis; Concepts and Practice* by Boardman et al.[210]

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[205] For more information about the extent of global implementation of CBA guidelines, *see* the World Bank Group's *Global Indicators of Regulatory Governance: Worldwide Practices of Regulatory Impact Assessments*, pgs. 6-7, available at http://documents1.worldbank.org/curated/en/905611520284525814/Global-Indicators-of-Regulatory-Governance-Worldwide-Practices-of-Regulatory-Impact-Assessments.pdf

[206] OMB Circular A-94 (2012), *Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs,* available at https://obamawhitehouse.archives.gov/the-press-office/2011/01/18/executive-order-13563-improving-regulation-and-regulatory-review

[207] The Regulatory Policy Committee, *Recommendations Used When Scrutinizing Impact Assessments*, available at https://www.gov.uk/government/publications/how-the-regulatory-policy-committee-scrutinises-impact-assessments/regulatory-policy-committee-recommendations-used-when-scrutinising-impact-assessments

[208] Admin. Conf. of the U.S., Recommendation 2013-2, *Benefit-Cost Analysis at Independent Regulatory Agencies,* 78 Fed. Reg. 41,355 (July 10, 2013). Pg. 56, available at https://www.acus.gov/sites/default/files/documents/Copeland%20Final%20BCA%20Report%204-30-13.pdf.

[209] Organisation of Economic Cooperation and Development, *Recommendation of the Council of Regulatory Policy and Governance* (2012), available at https://read.oecd-ilibrary.org/governance/recommendation-of-the-council-on-regulatory-policy-and-governance_9789264209022-en#page1

[210] BOARDMAN, A. E., GREENBERG, D. H., VINING, A. R., & WEIMER, D. L. COST-BENEFIT ANALYSIS; CONCEPTS AND PRACTICE (2018).

Perhaps unsurprisingly, there is broad agreement across these sources of expertise on the subject regarding the principles and best practices of CBA. Of course, there are differences in presentation, organization, and granularity of detail in the best practices across the resources, but there are very few (if any) contradictions between them. Using these resources and their own expertise, the Taskforce believes it has identified a comprehensive set of best practices for regulatory CBA.

The Taskforce believes that any CBA that fulfills the purposes mentioned above must at least adhere to the following principles and best practices:

1. **Analysis of the problem.** The agency should analyze the extent and nature of the problem it intends to correct. This analysis should include a discussion of any relevant market failures and present evidence in support of any claims of market failure. The discussion should also include any distributional concerns or problems related to fairness, equity, and human dignity.

2. **Definition of the baseline.** The agency should establish a baseline for comparing the cost and benefits of regulatory alternatives. This is usually more complicated than simply using data on compliance, production, or sales in the past. It usually involves forecasting sales or production into the future, as well as any potential voluntary compliance. The agency should take care to capture that benefits and costs of all existing protections in the baseline of the analysis, and that all benefits and costs attributed to the rule are marginal increases or decreases relative to existing requirements.[211] The agency should use a pre-statutory baseline to capture the full impacts of the regulation, but should also consider presenting the results using a post-statutory baseline to show the impacts flowing from the agency's discretion.

3. **Selection of a time horizon for the analysis.** Selecting a time horizon is an important part of regulatory analysis, and a potential source of bias if not done correctly. Because the timing of the costs and benefits of a regulation are often asymmetric, a time-horizon that is too short will bias the net benefits towards the earlier impacts. Unfortunately, there is no one size fits all approach to time-horizon selection, but generally agencies should strive to select a time-horizon to minimize bias. Product life cycles or refresh/redesign cycles are often instructive. Generally, due to discounting for social time preference, the longer the time-horizon of the analysis the smaller the potential bias.

[211] Chapter 6 of this report provides an example highlighting the importance of proper baselining, where debt-collection protections implemented the 1970s likely have had benefits exceeding costs. Now that those protections and the associated benefits and costs are in the baseline, the marginal net benefits of proposed new protections may be smaller and possibly negative. See Chapter 6 for more details.

4. **Identification of alternatives.** Various approaches to solving the problem(s) identified should be identified. These alternatives may include both regulatory and non-regulatory options, such as enforcement actions under existing authorities or use of other non-regulatory incentives to encourage the desired behavior. These alternatives may also consider the role of state and local governments in solving the problem. Commonly, alternative approaches analyzed vary by both regulatory stringency and/or scope of the universe required to comply.

5. **Analysis of benefits and costs.** The agency should estimate the costs and benefits of each alternative using the best available science and evidence. Cost estimates should reflect the full opportunity cost to society of diverting resources towards compliance with the regulation. Likewise, benefit estimates should consider opportunity costs – or the value of what society is willing to forego to enjoy a benefit. While there are many approaches to valuing benefits and costs, willingness-to-pay approaches that assess a benefit or cost based on revealed valuations in market transactions are particularly compelling.[212] The benefits and costs of *each alternative* should be quantified, aggregated, and monetized to the maximum extent possible. Any assessment of benefits must include an analysis of how effective each alternative would be at addressing the problems identified.

6. **Assessment of unintended consequences.** The analysis should include assessment of potential unintended consequences and include them in the estimates of benefits and costs.

7. **Discounting future benefits and costs.** Agencies should create schedules of benefits and costs and discount them the to present value using an appropriate social discount rate. There are several methods for determining the appropriate discount rate depending on the nature of the rule being analyzed and the time horizon of the analysis. Executive agencies use a range of 3 percent reflecting a risk-free rate of return and 7 percent reflecting the opportunity cost of capital.[213]

8. **Treatment of economic transfers.** An economic transfer occurs when a benefit to one person or group is exactly offset by a cost to another person or group. Common forms of transfers include government payments and welfare transfers between consumers and producers of a product associated with a change in price or change in market efficiency (e.g., reduction in market power results in some increased efficiency, but also a transfer from producers to consumers). These impacts are not comparable to benefits and costs and

[212] OMB Circular A-4 has an extended discussion of the various approaches to valuing benefits.

[213] *Id.*

should not be allowed to influence the estimated net benefits.[214] In some cases, transfers to certain groups may be part of the intent of the rule or statutory requirement. These cases often involve considerations of distributive impacts, fairness, equity, or human dignity – and these are the benefits the analysis should focus on (as opposed to the dollar value of the transfer). If those considerations are unavailable, the agency may consider a cost-effectiveness analysis in lieu of a cost-benefit analysis.

9. **Identification and analysis of uncertainty.** A CBA should identify key sources of uncertainty and discuss the potential impacts of that uncertainty on the results and conclusions of the analysis. For particularly important rulemakings, the agency should conduct sensitivity analyses to estimate the potential impact of that source of uncertainty on the analysis. If uncertainty is such that a determination as to whether the preferred regulatory approach has net benefits is impossible, the agency might consider whether to delay the rulemaking to explore the issue further.

10. **Incremental Analysis.** Many regulations contain multiple provisions that incur costs and generate benefits. For such rules, it is important that the net benefits of one provision aren't used to obscure the net costs of another – as doing so prevents the agency from identifying the alternative with the highest net benefits. The agency should independently assess the marginal contribution of each provision to the benefits and costs of the rule.

11. **Presentation of benefits, costs, transfers, and net benefits.** The aggregated and discounted benefits, costs, transfers, and net benefits should be summarized – usually in tabular form. Usually, this summary information is included in an introduction or executive summary, as well as a final chapter in the analysis.

12. **Policy Recommendation.** The analysis should recommend the alternative that maximizes benefits net of costs – including any non-quantified benefits. Non-quantified benefits may include distributional impacts or improvements in equity, fairness, or human dignity – though the agency should not foreclose the possibility that at least some portion of these benefits could be quantified and monetized. Note that if the agency were to reject the alternative that maximizes net benefits (including non-quantified benefits), the agency would have to explain its justification for doing so.

13. **Analytical transparency.** A CBA must be as transparent and reproducible as possible. It must be clear about the data sources, methodologies, and assumptions used to conduct the analysis. It must identify any limitations of the analysis and discuss the impacts those

[214] Note that there are two manners of accomplishing this. One is to account for transfers separately. The other is to include two symmetric entries into the accounting statement – one as a cost to one entity and the other as a benefit to another entity. Both approaches are valid.

limitations have on conclusions drawn from it. The analysis should be based on the best available science and evidence. Where the evidence supporting an analytical element is mixed, the agency should include a full or representative discussion of the varying sources of evidence and disclose how each source informed the analysis.

14. **Proportionality.** An agency should calibrate the amount of time and resources that go into regulatory analysis according to the importance of the decision they are analyzing. In other words, agencies should consider the costs and benefits of doing a cost-benefit analysis. For instance, executive agencies are not required to comply with OMB Circular A-4 for rules that are not designated economically significant (having an economic impact of greater than $100 million or more in any one year).

Valuing Benefits

On July 29, 2020, the CFPB hosted a Symposium on Cost-Benefit Analysis in Consumer Financial Protection Regulation, and one oft-repeated point among the panelists was a claim that the benefits of CFPB's regulations were often difficult to quantify.[215] Some who made this point argued that cost estimates are simpler to estimate than benefits and that the presence of cost estimates and the absence of benefit estimates were a source of bias in agency decision-making. While the Taskforce is unaware of any evidence to substantiate such a bias, it is aware that the benefits of regulation are often more difficult to estimate than the costs.[216] This is partly due to the fact that many sources of regulatory cost are relatively straightforward to estimate – materials, labor and consumer time, technology, etc. These are all resources that are widely transacted in transparent markets with available data. On the other hand, benefits of regulation are often driven by factors that are traded in less transparent markets – or are not traded in markets at all. For instance, the fraud and privacy protections offered by a creditor are a small fraction of the total bundle of services a consumer purchases in a credit transaction. So even if the consumer explicitly shops on these attributes and makes rational consumption choices pertaining to fraud and privacy protection, it can be difficult to determine the consumer's willingness to pay for these items versus the other attributes involved in the purchase.

That said, the economics discipline has developed several tools for assessing the value of the benefits of regulation, and these tools have been applied broadly in CBA conducted by executive agencies. A fulsome discussion of these tools would be too tedious and intricate to go into here,

[215] Hall, Stephen, *Written Remarks of Better Markets for the CFPB Symposium on Cost-Benefit Analysis in Consumer Financial Protection Regulation.* July 29, 2020. https://files.consumerfinance.gov/f/documents/cfpb_hall_written-statement_symposium-cost-benefit-analysis.pdf

[216] Worth noting, however, that in the case of the CFPB analyses reviewed by the Taskforce total cost estimates are about as rare as total benefit estimates.

but useful and detailed information about them can be found in OMB Circular A-4, Boardman et al., and Hanley et al.[217] The most obvious example of the application of these tools to estimate sensitive and difficult-to-measure benefits is the Value of Statistical Life (VSL) used in health, safety, and environmental regulation to value life-saving benefits.[218] In this case, the most popular approach to estimating the VSL is to apply hedonic pricing model – an econometric technique for teasing out the value consumers place on any single attribute in a transaction – to labor markets to see how much additional compensation workers demand for accepting an incremental increase in mortality risk on the job. The resulting value is quite high – at least compared to other measurements of the value of mortality risk (e.g., wrongful death settlements). The value used by the Department of Transportation is over $9 million.[219]

To some, the difficultly in estimating benefits is a fatal blow to CBA, but the VSL seems to offer a counterpoint to this view. While the development of the VSL was surely a long, laborious effort on the part of many researchers in government and the academy, it has been used to justify many costly regulations – many with total costs in the billions of dollars per year.[220] Mark Cohen, another panelist at the symposium, argues a similar point that the justification for Department of Justice's Prison Rape Elimination Act rulemaking was improved by valuing the reduction in the incidence of prison rape.[221] Therefore, while benefit valuation may be difficult, doing the work to develop values may serve to advance the policies preferred by advocates, rather than weaken them.

Cohen's testimony also suggested a framework the CFPB could use if it sought to expand its analysis of benefits in its regulatory analysis program. Cohen argued that, in addition to looking at the monetary damages associated with the consumer harms CFPB regulates, the agency should also value avoided indirect costs of harm, such as time spent remedying the problem and the psychological distress associated with the harm (which can sometimes lead to physical injury

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[217] HANLEY, N., SHOGREN, J.F, WHITE, B. ENVIRONMENTAL ECONOMICS IN THEORY AND PRACTICE, 2ND ED., (2007).

[218] US Department of Transportation, Guidance on Treatment of the Economic Value of a Statistical Life (VSL) in US Department of Transportation Analyses – 2015 Adjustment (2015), available at https://www.transportation.gov/sites/dot.gov/files/docs/2015%20Revised%20Value%20of%20a%20Statistical%20Life%20Guidance.pdf

[219] *Id.*

[220] For example, one rule supported by the VSL is the Department of Transportation's "Electronic Stability Control Systems" Final Rule (72 FR 17235), where the Department estimated the rule would reduce roadway deaths by 1,547 to 2,534 annually. These benefits, when monetized, range from $6 billion to $12 billion annually, which exceed the hefty $985 million annual costs of the rule. See Docket ID: NHTSA-2007-27662-0002.

[221] Cohen, Mark, *CFPB Symposium: Cost-Benefit Analysis in Consumer Financial Protection Regulation*. July 29, 2020, available at https://files.consumerfinance.gov/f/documents/cfpb_cohen_written-statement_symposium-cost-benefit-analysis.pdf

or suicide). This is a very important point, and these are very important benefits for the agency to consider as the direct monetary harm may be considered a transfer in some instances. Cohen continues to suggest potential methodologies for assessing the value of avoiding such harms and argues they could be relevant to a wide range of benefits concerning CFPB regulations – including fraud, privacy protection, and even racial discrimination.[222]

Cohen's suggested approach is quite similar to the approach health, safety, and environmental regulators take toward estimating injury, illness, and mortality risk reduction benefits associated with their regulations, which treat health and safety hazards as ex-ante risks which can be reduced by regulation, though rarely eliminated completely. This approach would recognize that there is some risk of consumer harm associated with all financial products and transactions, and that banning, eliminating, or reducing a practice or product may eliminate some harms associated with it, but may expose consumers to harms elsewhere as consumers substitute towards similar products. Therefore, evaluation of the effectiveness of a proposed rule at reducing consumer harm should consider the risks associated with similar products.

Jackson and Rothstein (2019) reach similar conclusions, as they also point out that the environmental regulatory arena has been able to develop benefit estimates for use in CBA such as the VSL and the Social Cost of Carbon. They suggest the development of values for avoided bankruptcies, foreclosures, and financial stress. Jackson and Rothstein also acknowledge that some "benefits" of consumer protection regulation are transfers from an economic perspective. They point out that literature on valuing theft reduction and charitable contributions could be a starting point for future research. They also suggest that an estimate could measure the extent to which transfers move consumers away from financial distress could be appropriate, and that the insurance value of risk reduction could be helpful.[223]

The CBA best practices identified in this Chapter emphasize that CBA must accommodate qualitative benefits when making a recommendation as to the most net-beneficial regulatory alternative. This includes benefits that are difficult to quantify related to human dignity, fairness, and distributional issues. However, this doesn't mean that these matters cannot be quantified or that the agency should refrain from attempting it. Quantification may further refine the agency's views of an issue – and while it may reveal that a problem is less of an issue than previously thought, it may also show that a problem is much greater than the agency previously thought and that more should be done to address it.

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[222] *Id.*

[223] Howell Jackson and Paul Rothstein, *Analysis of Benefits in Consumer Protection Regulation*, HARVARD BUSINESS LAW REVIEW, 199 (2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3659474

Implementation of CBA

Regulatory CBA best practices are often implemented alongside the creation or establishment of an oversight body that reviews regulatory analyses for quality and compliance. These oversight bodies can play a variety of roles in the development of regulations and regulatory analyses, including providing general guidance on implementing CBA, reviewing regulations and regulatory analyses for consistency with best practices prior to publication, and making public statements about the quality of regulatory analyses.

In 2012, OECD recommended that each of its member nations establish policies and principles of regulatory CBA, as well as "[e]stablish mechanisms and institutions to actively provide oversight of regulatory policy, procedures, and goals, support and implement regulatory policy, and thereby foster regulatory quality."[224] Since 2012, OECD has been monitoring implementation of its recommendations in member countries and has reported data on where this review function sits in the government. The most prominent location for oversight and review is the "Center of Government." The second most popular location for these functions is a "non-departmental body" at arms-length from central government. Other popular locations are Finance, Treasury, or Justice departments.[225]

In the United States, the oversight and review functions are played by the Office of Information and Regulatory Affairs (OIRA) within the OMB, which functions within the Executive Office of the President (EOP). The location of OIRA within the White House almost certainly lends power and influence to the office, but it also means that OIRA is ultimately controlled by political forces.[226] Depending on your perspective, this could be a democratizing influence on technical decision-making, or it could be viewed as a political intrusion.

OIRA's role in the regulatory process is multifaceted, which is governed by EO 12866.[227] During review, OIRA consults with regulators and provides advice on both the regulatory analysis and the decisions it supports. In addition to serving as a CBA resource and reviewer, OIRA moderates interagency disputes and coordinates the White House's review of agency

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[224] Organisation of Economic Cooperation and Development, *Recommendation of the Council of Regulatory Policy and Governance* (2012), available at https://read.oecd-ilibrary.org/governance/recommendation-of-the-council-on-regulatory-policy-and-governance_9789264209022-en#page1

[225] Organisation of Economic Cooperation and Development, *OECD Regulatory Policy Outlook 2018*, Chapter 3, OECD Publishing, Paris (2018), available at https://doi.org/10.1787/9789264303072-en.

[226] Cass Sunstein provides background and an account of his time as Administrator of OIRA in his book *Simpler, The Future of Government.* SUNSTEIN, C., SIMPLER; THE FUTURE OF GOVERNMENT (2013).

[227] President Clinton's Executive Order 12866, *Regulatory Planning and Review,* (1993), available at https://www.archives.gov/files/federal-register/executive-orders/pdf/12866.pdf.

regulations.[228] Typically, OIRA review concludes without any public statement as to the quality of the analysis or the rulemaking generally. On rare occasions when OIRA exercises its authority to return a regulation to an agency for reconsideration, a public return letter is released detailing analytical deficiencies.[229] Importantly, independent regulators, including CFPB, are not required to comply with OIRA guidance and are not subject to OIRA review.

While the U.S. may exemplify the "Center of Government" approach, the United Kingdom's RPC is an example of an independent, or non-departmental, oversight and review office. In contrast to OIRA, the RPC issues a public opinion of each of the regulatory analyses they review. The analysis is given an overall rating based on whether it was "fit for the purpose," as well as summarizing the analysis and offering critiques. However, the RPC has no impact on regulatory decisions above and beyond the impact of their public and technical opinions.

The differences between the two oversight and review offices are interesting. The OIRA model is powerful and integrated into the decision-making process. But perhaps because of its role in managing the decision-making process, its analytical findings are rarely made public. In contrast, the RPC is highly transparent with its findings and has pointed to the increasing percentage of analyses that receive the "fit for the purpose" grade as an indication that their review is influential.[230]

Scholarship on the impact of regulatory oversight on quality of CBA is limited. However, Howell Jackson and Paul Rothstein conducted a survey of 72 consumer protection regulatory analyses from across the federal government that showed that regulations reviewed by OIRA showed a greater degree of quantification than regulations conducted by independent agencies not subject to OIRA review.[231]

Evaluation of CFPB's Regulatory Guidance "Regulatory Analysis Policies and Procedures for Substantive Rulemaking"

The Taskforce reviewed the Bureau's guidance for rulemaking analysis "Regulatory Analysis Policies and Procedures for Substantive Rulemaking" (RAPP) for consistency with the

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[228] SUNSTEIN (2013), *supra* note 226 Chapter 1, pages 30-31.

[229] OIRA return letters are catalogued at https://www.reginfo.gov/public/do/eoReturnLetters

[230] Regulatory Policy Committee, Assessing Regulation; An Independent Report on the Evidence and Analysis Supporting Regulatory Proposals, January – August 2012(2012), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/252697/assessingregulationrpcnov2012report.pdf

[231] Howell Jackson and Paul Rothstein, *Analysis of Benefits in Consumer Protection Regulation*, HARVARD BUSINESS LAW REVIEW, 199 (2019), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3659474

regulatory best practices. The Taskforce found several areas of agreement, but also areas where there is some tension between the Bureau's approach and the Taskforce's best practices. This section summarizes our findings from the review.

The guidance identifies market failures as a potential justification for regulation and provides that the Bureau should consider whether the underlying statute addresses any market failures. The agency also lists privacy and the dignity of consumers as other potential purpose of regulation. The guidance does not provide any direction on the evidentiary support needed to justify a market failure claim.

The RAPP directs Bureau analyses to define a baseline in a manner that is generally consistent with the best practices mentioned above – indicating that it is matter of professional judgment that requires consideration of a broad set of factors and circumstances. The RAPP advises staff to consider discounting future costs and benefits, consistent with CBA best practices.

The guidance provides potentially contradictory direction on selection of the time horizon of the analysis. First it suggests "[a] possible ending point is the date at which staff expects to review a rule." It appears this refers to the five-year retrospective review schedule the agency has in place. This direction is highly unlikely to be an appropriate time horizon for an analysis, as it is likely the rule has asymmetric costs and benefits that continue out beyond five years. However, the RAPP also provides that the Bureau should seek to identify "the pattern in which the benefits, costs, and impacts will occur over time." This latter guidance is entirely consistent with the best practices mentioned above and would not generate any biases toward earlier impacts.

The RAPP does provide that the Bureau should identify alternatives. However, while the guidance is permissive of a quantitative analysis of alternatives, it does not indicate that the Bureau must or should analyze alternatives quantitatively. Given the fundamental importance of the inclusion of alternatives in the quantitative assessment, this is a divergence from CBA best practices.

The guidance in the RAPP on quantifying and monetizing benefits are generally consistent with the best practices above, with some exceptions. First, the guidance does not specify that costs and benefits should include opportunity costs. Second, the guidance does not emphasize that benefits and costs should be aggregated, quantified, and monetized to the maximum extent possible.

A charitable read of the RAPP guidance would suggest that unintended consequences are contemplated in the assessment of costs and benefits. But there is no explicit guidance on how the Bureau should analyze and treat unintended consequences. Regulations change behavior by changing the price and choices of goods and services, as well as the quantities available. It is important for regulators to systematically analyze the potential ramifications of regulatory options – both positive and negative. CFPB staff indicate to the Taskforce that identification of potential unintended consequences is a routine aspect of their regulatory development.

The RAPP guidance may have intended to separate transfers from costs and benefits, but this is not explicitly addressed. Identification and qualification of transfers are key elements of CBA, and the absence of guidance on the subject is a divergence from the best practices. For instance, the CFPB's authorities related to competition (RESPA and TILA) and fair lending have significant transfer implications that require careful consideration.

The guidance is generally consistent with best practices regarding treatment of uncertainty. It indicates that uncertainty around assumptions should be described and advises staff to use sensitivity analyses to "examine how figures would change with plausible changes in assumptions and data."

The RAPP doesn't explicitly direct staff analysts to conduct an incremental assessment of each provision of a rule, though it does advise "it may be appropriate to proceed through the relevant provisions of the regulation, discussing the benefits and costs on each affected group at the end." CFPB staff have indicated to the Taskforce that alternative thresholds are considered as a matter of routine.

The most significant divergence of the guidance from best practices is that it does not provide direction on comparing costs and benefits, summarizing other impacts, and recommending a preferred alternative.

Results of Taskforce Review of CFPB Analyses of Major Rulemakings

The Taskforce reviewed the analyses of every CFPB rulemaking designated as Major under the Congressional Review Act between the years of 2013 and 2018 to better understand how the agency implements cost-benefit analysis.[232] The Taskforce reviewed for consistency with CBA principles and best practices, as well as Section 1022 of the Dodd-Frank Act.

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[232] For this analysis, the Task Force reviewed the Section 1022 analyses of the following regulations: Home Mortgage Disclosure Act (Regulation C) (RIN: 3170-AA10; 80 FR 66127), Loan Originator Compensation Requirements Under the Truth in Lending Act (RIN: 3170-AA13; 78 FR 11279), Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X) (RIN: 3170-AA14; 78 FR 10695), Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) (RIN: 3170-AA19; 78 FR 80225), Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z) (RIN: 3170-AA17; 12 CFR 1026), Prepaid Accounts Under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z) (RIN:3170-AA22; 81 FR 83934), Payday, Vehicle Title, and Certain High-Cost Vehicle

As a new agency, the Bureau has been required to develop new approaches to regulatory analysis. Where other agencies have had years to develop complicated models and sophisticated estimates of key elements of their regulatory programs, the CFPB is often regulating in spaces where the body of academic and other research available is very small. Thus, CFPB is often in the challenging position of developing new methodological approaches to advance its regulatory analysis program, and the Taskforce has noticed that the quality of the Bureau's regulatory analyses has improved over time. Furthermore, the Taskforce is aware that the CBA principles and best practices identified by the Taskforce in this Chapter go above and beyond what is required of the Bureau by Section 1022 of the Dodd-Frank Act. As such, a retrospective review for consistency with standards the Bureau was not required to satisfy cannot and should not be viewed as an assessment of performance. No agency perfectly implements the principles set forth above. Instead, these reviews should be seen as a "gap analysis" seeking to understand the difference between current practices and those identified above, where further improvements are possible. In some instances, it may appear that the Taskforce is recommending wasteful analysis when fundamental policy decisions are made in statute. In the view of the Taskforce, lack of statutory discretion is not justification for excluding key elements of a regulatory analysis. Recall that the purpose of regulatory CBA is to improve regulatory decisions; enhance transparency; and promote accountability and credibility – and each of these purposes are advanced by an analysis of the problem, consideration of alternatives, and every other best practice mentioned above. The Bureau's expertise on these matters could reveal to Congress the availability of a more net-beneficial approach to solving a problem that may prompt Congress to revisit the statute. If the implementation time horizon is long enough, the agency may provide technical advice to Congress on the potential to improve regulatory outcomes prior to implementation. Even if Congress is not swayed by the technical expertise of the agency, the CBA would still provide transparency on the estimated impacts of Congressional decisions and invite the public to hold it accountable for those decisions. For similar reasons, EO 12866 requires executive agencies to conduct CBA of significant rules even when Congress has dictated the policy choice by statute.

Installment Loans (3170-AA40; 82 FR 54472), Arbitration (RIN: 3170-AA51; 82 FR 33210), Operations in Rural Areas Under the Truth in Lending Act (Regulation Z) (RIN: 3170-AA59, 81 FR 16074), Amendments to Federal Mortgage Disclosure Requirements Under the Truth in Lending Act (Regulation Z) (RIN: 3170-AA61; 82 FR 37656).

13.8 Conclusions from Taskforce Review of Agency Analyses

13.8.1 Analysis of the Problem

Most of the Bureau's analyses feature some discussion of market failures and/or other problems they are trying to solve. In some circumstances, the Bureau even supports these market failure claims with evidence. For instance, in the 2013 final rule amending mortgage servicing rules under RESPA and TILA, the Bureau provided a summary of the literature on the external costs of foreclosure. Also, the 2017 Payday Lending final rule attempted to justify its market failure claim with an extended discussion and analysis of the evidence concerning consumer expectations of payday lending products.[233] However, the Bureau did not provide evidence to support its claims of market failure in every rule reviewed by the Taskforce. Of the 10 analyses reviewed, the Taskforce found evidence to support market failure claims in three of those analyses and found no or very weak evidence to support market failure claims in three analyses.[234]

It is important to note that the analysis of the problem shouldn't involve simply listing every potential market failure that could be potentially relevant.[235] Instead, it should be a careful assessment of the nature of the actual problem(s) for which mitigation is the true purpose of the rule. Furthermore, CBA best practices don't *require* that a market failure be present to justify regulation. For instance, a regulation may improve enforcement of standards in an efficient manner – and thus the net benefits of improved compliance with existing standards become the net benefits of the new rule – and this may be sufficient rationale. The 2013 HMDA rule did identify improved compliance and enforcement with fair lending and other standards as part of the purpose of the rule, and the benefits identified by the analysis are more connected to this

[233] Payday, Vehicle Title, and Certain High-Cost Vehicle Installment Loans (3170-AA40; 82 FR 54472).

[234] Evidentiary support for market failure claims was not germane to the remaining analyses for one reason or another. For instance, rules intended to enhance compliance with existing standards do not rely on claims of market failures. Rules where the Taskforce did not find evidence, the evidence presented was very weak, were Prepaid Accounts Under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z) (RIN:3170-AA22; 81 FR 83934), Home Mortgage Disclosure Act (Regulation C) (RIN: 3170-AA10; 80 FR 66127), and Loan Originator Compensation Requirements Under the Truth in Lending Act (RIN: 3170-AA13; 78 FR 11279)

[235] Howell Jackson referred to this common phenomenon in consumer protection CBA as having a "throw-in-the-kitchen-sink flavor." Howell Jackson, *CFPB Symposium: Cost-Benefit Analysis in Consumer Financial Protection Regulation* (July 29, 2020), available at https://files.consumerfinance.gov/f/documents/cfpb_jackson_written-statement_symposium-cost-benefit-analysis.pdf .

problem than any market failure claim.[236] The analysis (and the decision-making it contributes to) may have been better off if it focused more on this issue, as well as the human dignity issues associated with improved compliance with fair lending rules. Similarly, the Bureau's 2017 Arbitration final rule appropriately identified increased compliance with existing standards in its regulatory analysis.

13.8.2 Estimating Benefits, Costs, and Transfers

Aggregating costs and benefits are essential in CBA, as it makes comparing costs and benefits possible. In two analyses reviewed by the Taskforce, the Bureau presented aggregated cost and/or cost-savings estimates.[237] In the remaining analyses reviewed by the Taskforce, however, the Bureau does not endeavor to generate total cost and benefit estimates, even if unit or ongoing cost and benefit estimates are provided. In many cases, the lack of quantification and monetization owes to insufficient data, information, or literature – but there are other instances when greater quantification and monetization were possible.[238]

Analyzing the effectiveness of each alternative is an important part of benefits estimation. In some instances, the Bureau has conducted robust evaluations of the effectiveness of their preferred option. For example, the 2014 rule integrating the RESPA and TILA mortgage disclosure forms presented evidence that the revised disclosure was easier to understand. In other instances, the assessment of effectiveness is quantitative in nature but incomplete.[239] In the remainder of the analyses reviewed, the Taskforce was unable to locate assessments of effectiveness. While it is possible that the cost of research required to assess the effectiveness of the Bureau's regulations outweigh the benefits of that information, the Taskforce notes that it

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[236] A good rule of thumb is that if the benefits you identify aren't connected to a problem you identify, you have the wrong problem, the wrong benefits, or both.

[237] Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) (RIN: 3170-AA19; 78 FR 80225) and Arbitration (RIN: 3170-AA51; 82 FR 33210). No other rule reviewed by the Task Force presented total cost and benefit estimates.

[238] As one example, the Bureau frequently references the benefits associated with reduced foreclosures (Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X) (RIN: 3170-AA14; 78 FR 10695)), but does not attempt to quantify these benefits even when estimates of the external costs of foreclosure have been developed and used by other agencies. The Department of Housing and Urban Development used a cost of foreclosure estimate of $10,339 in its Regulatory Impact Analysis for its Emergency Homeowners Loan Program. *See* Hollar, *Regulatory Impact Analysis: Emergency Homeowners Loan Program* (2011), available at https://www.huduser.gov/portal/periodicals/cityscpe/vol13num2/Cityscape_july2011_impact.pdf. In another example, the 2017 Payday Lending rule, the Bureau estimates the time cost of training employees, but does not use readily available wage information from BLS to monetize it.

[239] For instance, the analysis of the Payday, Vehicle Title, and Certain High-Cost Vehicle Installment Loans (3170-AA40; 82 FR 54472) final rule includes effectiveness at preventing the subject loans, but not the effectiveness at reducing consumer harm. The rule may prevent some harms by preventing risky loans, but consumers may shift to other risky loan products that expose borrowers to harms.

only reviewed regulations designated as Major under the Congressional Review Act. Given the large impacts of this sample of regulations, the benefits of information on the potential effectiveness of the Bureau's interventions are likely significant.

In those cases where the Bureau estimates benefits or costs over the course of several years, the Bureau does tend to discount those future impacts back to present value, appropriately. However, the justification for the selection of the time horizon of the analysis is often missing or non-transparent.[240] The Taskforce also noticed that the Bureau often amortizes upfront costs over a number of years without a clear justification, instead of putting them in the first year of the analysis.[241]

Finally, the Taskforce notes that it did not find a discussion of economic transfers in any of the regulations it reviewed. This may be due to the nature of the requirements under Section 1022 of the Dodd-Frank Act, which specifically require the Bureau to assess costs and benefits to specific groups, rather than society writ-large. If, owing to the nature of these statutory requirements, the Bureau is treating transfers as symmetric costs to some entities that are benefits to others, the Bureau is dealing with transfers appropriately.

13.8.3 Treatment of Alternatives

The Bureau's treatment of alternatives is a significant divergence from CBA best practices. In four of the 10 regulations reviewed by the Taskforce, the Bureau did not identify alternatives to the regulatory option it selected.[242] In those rules where the Bureau identified alternatives, they were generally excluded from the quantified and monetized analysis. The Taskforce identified one exception to this in the 2013 HMDA rule, where the Bureau quantitatively analyzed alternative reporting thresholds for closed-end mortgages – though this was not a fully monetized cost-benefit analysis. Other important level-setting decisions have gone without a quantitative assessment.[243] Generally, when the Bureau identified alternatives, they were considered in a separate section from the primary analysis and did not receive the same level of

[240] This statement applies to all rules reviewed by the task force.

[241] For example, see Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) (RIN: 3170-AA19; 78 FR 80225)

[242] Operations in Rural Areas Under the Truth in Lending Act (Regulation Z) (RIN: 3170-AA59, 81 FR 16074); Amendments to Federal Mortgage Disclosure Requirements Under the Truth in Lending Act (Regulation Z) (RIN: 3170-AA61; 82 FR 37656); Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X) (RIN: 3170-AA14; 78 FR 10695); and Loan Originator Compensation Requirements Under the Truth in Lending Act (RIN: 3170-AA13; 78 FR 11279)

[243] For instance, the 2017 Payday Lending Rule's maximum loan limit of $500 seems to have been chosen without quantitatively analyzing alternative levels.

rigor as the primary alternative. The Taskforce did not identify an analysis where an alternative approach was both quantified, monetized, and then compared with the regulatory option selected.

13.8.4 Policy Recommendation and Summary Information

None of the analyses reviewed by the Taskforce summarized, tabulated, and compared cost and benefits.[244] Even when costs and benefits are available, net benefits are not presented or calculated and there are no qualitative summary discussions evaluating the tradeoffs. Omitting the presentation of cost and benefits, as well as any form of discussion evaluating the tradeoffs associated with alternative approaches, reduces the probability that the Bureau's CBAs would achieve the purposes of improving decisions, advancing transparency, and enhancing credibility and accountability. The omission also forecloses the possibility that the CBA could recommend a policy alternative. This is an important and meaningful contrast between the best practices identified above (as well as the purposes of CBA) and CFPB's current practice.

13.8.5 Uncertainty

At times, the Bureau has shown commitment to highlighting uncertainty and dealing with it appropriately. For instance, the 2013 Ability-to-Repay rule conducted an excellent sensitivity analysis for its liability cost estimates in response to comments that legal fees were likely to be higher than estimated at the proposed rule stage and the amount of billable hours were likely to be longer. In another example, the Bureau's 2013 rule on Loan Originator Compensation features a frank discussion of state of the literature on the subject:

The Bureau, however, notes that the current state of academic research has not provided an unequivocal answer to the question of whether any given profit-based compensation arrangement will produce incentives sufficiently strong for individual loan originators to engage in consumer steering. The Bureau also notes that this research, whether based on theoretical or empirical methods, shows that the potential for any profit-sharing plan to create adverse incentives are acutely sensitive to the specific features of the working environment and the means by which such profits are distributed to the relevant individual loan originators. Finally, the Bureau notes that any potential reduction in the strength of these incentives is almost surely insufficient, under all realistic circumstances, to eliminate them entirely.[245]

[244] Importantly, the Bureau's 2017 Arbitration final rule (RIN: 3170-AA51; 82 FR 33210) did present a table of a significant portion of the estimated and aggregated costs.

[245] Loan Originator Compensation Requirements Under the Truth in Lending Act (RIN: 3170-AA13; 78 FR 11279)

Otherwise, the Taskforce's review revealed that uncertainty rarely received quantitative treatment. In its review of ten of Major rulemakings (that is, rules expected to have an annual impact of over $100 million), the Taskforce identified one sensitivity analysis.

13.8.6 Consistency with Section 1022 of the Dodd-Frank Act

As discussed above, the CBA requirements in Section 1022 of the Dodd-Frank Act have universe components (e.g., groups of people the analysis should cover), and content components (costs, benefits, and loss of access to financial products). The Taskforce's review finds that the Bureau does very well in addressing the universe components of the Act. In fact, the Bureau organizes their CBA according to the identified groups of people and business identified in the Dodd-Frank Act and explicitly addresses costs and benefits to each group.

The Taskforce's review of CFPB's regulatory analyses revealed that the Bureau does consider the potential reduction in access by consumers to consumer financial products or services. However, these considerations could be explained more transparently. Often, the Bureau provides a statement that it considered issues related to access without providing its methodology and without explaining how access was factored into its decision – even in cases when the Bureau estimates increased costs that may be passed on to consumers.[246]

13.8.7 Summary of Findings

The Taskforce's review of CFPB's regulatory analyses identified several gaps between the Bureau's implementation of CBA and the best practices identified above. Notable gaps between the Bureau's approach and best practices include a lack of identification, quantification, and monetization of regulatory alternatives; quantification and monetization of benefits and costs; presentation of costs, benefits, and net benefits of each alternative considered; and a policy recommendation.

However, the Taskforce did identify some areas of consistency with best practices. For instance, the Bureau did discount future impacts back to present value using an appropriate discount rate when it did endeavor to quantify and monetize a value. Also, the Taskforce believes the Bureau has complied with the universe components of the Dodd-Frank Act's statutory mandate to consider costs and benefits. The Taskforce does note, however, that the CFPB's implementation

[246] *See* Home Mortgage Disclosure Act (Regulation C) (RIN: 3170-AA10; 80 FR 66127), Loan Originator Compensation Requirements Under the Truth in Lending Act (RIN: 3170-AA13; 78 FR 11279), Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X) (RIN: 3170-AA14; 78 FR 10695).

of the Dodd-Frank Act's requirement to consider access to financial products could be more transparent.

CHAPTER 13, APPENDIX A:

Federal Financial Regulators and Who They Supervise[247]

Table 1. Federal Financial Regulators and Who They Supervise

Regulatory Agency	Institutions Regulated	Other Notable Authority
	Depository Regulators	
Federal Reserve	Bank holding companies and certain subsidiaries (e.g., foreign subsidiaries), financial holding companies, securities holding companies, and savings and loan holding companies Primary regulator of state banks that are members of the Federal Reserve System, foreign banking organizations operating in the United States, Edge Corporations, and any firm or payment system designated as systemically significant by the FSOC	Operates discount window ("lender of last resort") for depositories; operates payment system; conducts monetary policy
Office of the Comptroller of the Currency (OCC)	Primary regulator of national banks, U.S. federal branches of foreign banks, and federally chartered thrift institutions	
Federal Deposit Insurance Corporation (FDIC)	Federally insured depository institutions Primary regulator of state banks that are not members of the Federal Reserve System and state-chartered thrift institutions	Operates deposit insurance for banks; resolves failing banks
National Credit Union Administration (NCUA)	Federally chartered or federally insured credit unions	Operates deposit insurance for credit unions; resolves failing credit unions

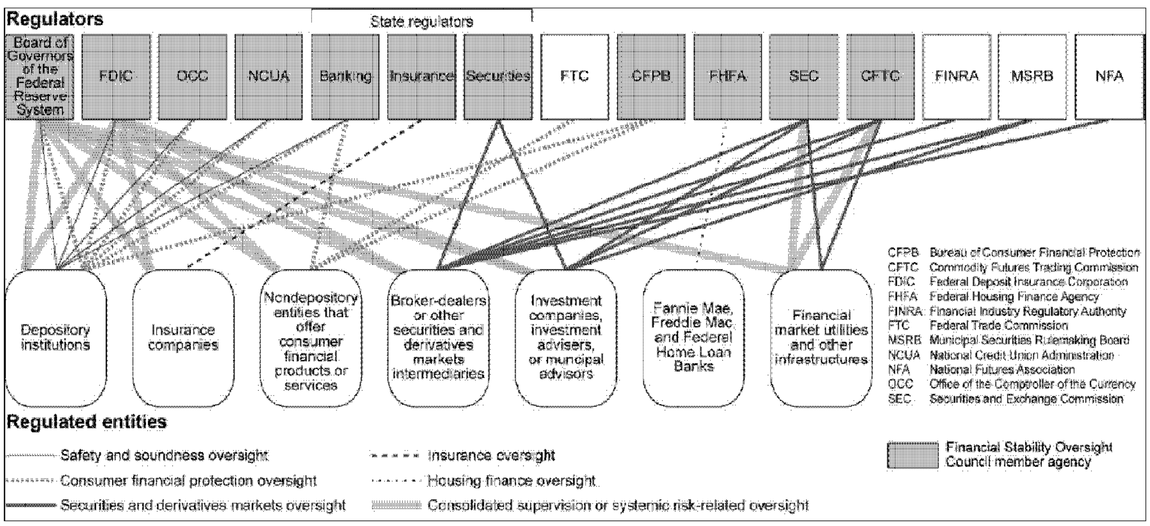
[247] Congressional Research Service, Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework title, R44918 (2020).

	Securities Markets Regulators	
Securities and Exchange Commission (SEC)	Securities exchanges; broker-dealers; clearing and settlement agencies; investment funds, including mutual funds; investment advisers, including hedge funds with assets over $150 million; and investment companies	Approves rulemakings by self-regulated organizations
	Nationally recognized statistical rating organizations	
	Security-based swap (SBS) dealers, major SBS participants, and SBS execution facilities	
	Securities sold to the public	
Commodity Futures Trading Commission (CFTC)	Futures exchanges, futures commission merchants, commodity pool operators, commodity trading advisors, derivatives clearing organizations, and designated contract markets	Approves rulemakings by self-regulated organizations
	Swap dealers, major swap participants, swap execution facilities, and swap data repositories	
	Government-Sponsored Enterprise Regulators	
Federal Housing Finance Agency (FHFA)	Fannie Mae, Freddie Mac, and Federal Home Loan Banks	Acting as conservator (since Sept. 2008) for Fannie and Freddie
Farm Credit Administration (FCA)	Farm Credit System, Farmer Mac	
	Consumer Protection Regulator	
Consumer Financial Protection Bureau (CFPB)	Nonbank mortgage-related firms, private student lenders, payday lenders, and larger "consumer financial entities" determined by the CFPB	
	Statutory exemptions for certain markets	
	Rulemaking authority for consumer protection for all banks; supervisory authority for banks with over $10 billion in assets	

CHAPTER 13, APPENDIX B:

Regulatory Jurisdiction by Agency and Type of Regulation[248]

Figure 1. Regulatory Jurisdiction by Agency and Type of Regulation



Source: Government Accountability Office (GAO). *Financial Regulation*, GAO-16-175, February 2016, Figure 2.

[248] Congressional Research Service, Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework title, R44918 (2020).