

Statement of Mark A. Cohen¹

CFPB Symposium: Cost-Benefit Analysis in Consumer Financial Protection Regulation

July 29, 2020

This panel addresses the important question about what methodological improvements the CFPB might make in its assessment of consumer financial policy and regulation. To summarize my comments, although financial regulation appears to be focused on the reduction of monetary harm, the indirect consequences of consumer harm can be extremely consequential. Those indirect consequences might be both monetary and psychological – resulting in serious mental and/or physical health issues. Moreover, consumer harm might extend beyond those who are ultimately victimized – and might include the public at large who are either potential victims or who value a fair marketplace for others. The state-of-the-art in regulatory policy analysis has progressed to the point that data can be collected, and methodologies have been developed to account for these impacts. To ignore these potential harms might seriously underestimate the potential benefits of consumer protection.

By way of introduction, I am an economist who has studied consumer protection issues since I began my career in 1985 as a staff member in the Bureau of Economics at the Federal Trade Commission. Among other things, my relevant research has included valuing consumer harm from fraud and crime, as well as estimating the incidence and costs of discriminatory lending practices on minorities. With this background in mind, let me briefly address the four questions posed to the panelists.

Data

While the question posed to the panel focuses on the potential need for producer/service provider data, I want to focus instead on the consumer side of the equation. In particular, even if existing datasets can be used to estimate the average interest rate or fees paid by borrowers – and potentially to identify overcharges or costs that consumers were unaware of at the time of purchase, late payments, servicing errors, or foreclosures - these costs might significantly under-estimate actual consumer harm. One of the key tenants of benefit-cost analysis is to first identify all potential costs and benefits (Boardman, Greenberg, Vining, & Weimer, 2011). Moreover, to the extent possible, these costs should be quantified and monetized. In the context of consumer protection, data is needed in three areas: (1) indirect costs, (2) nonmonetary costs, and (3) distributional impacts. Since the panel was asked to specifically focus on distributional impacts, I will discuss that issue later. Here, I focus on indirect and nonmonetary costs.

Indirect costs. Consumer harm beyond direct monetary overcharges can come from two sources. First, consumers may spend time in remedying the harm – perhaps dealing with financial institutions, credit reporting agencies, law enforcement, etc. These time costs can ultimately be monetized – but first data must be collected through surveys to understand the extent to which consumers are inconvenienced. Second, in some cases, consumer monetary harm might extend beyond the direct transaction involving

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the financial institution under CFPB jurisdiction. For example, a consumer whose credit rating is hurt might ultimately be unable to obtain employment or a loan. While I note that the CFPB has identified some of these potential harms in its rulemaking background documents – for example, noting the indirect consequences of foreclosure on children’s health or neighboring home prices (see e.g., Mortgage Servicing Rules under the Real Estate Settlement Act, 12 CFR 1024, Federal Register 10854), none of these harms appear to be quantified yet alone monetized. Even though such data may not have been collected previously, there is precedent for government agencies to conduct public surveys to obtain data such as the incidence of various types of consumer harm. For example, the FTC has sponsored a series of consumer fraud surveys (Anderson, 2013), and Bureau of Justice Statistics has begun to include more detailed survey questions about identity theft on the National Criminal Victimization Survey (NCVS) (Harrell, 2019).

Nonmonetary/intangible costs²

In addition to the value of time and other indirect monetary costs, consumers who are victimized by unfair, deceptive or fraudulent trade practices might suffer from psychological distress. For example, the most recent NCVS survey on identity theft indicated that 10% of victims reported suffering “severe distress” from the incident (Harrell, 2019). In extreme cases such as the Madoff scandal, victim impact statements have identified symptoms of severe psychological distress that have been characterized as “fraud trauma syndrome” in some cases leading to suicide (Glodstein, Glodstein, & Fornaro, 2010). While the incidence of these extreme outcomes might be relatively rare, they are important to identify and quantify – both because the impact on individuals might be extreme and, in the aggregate, they can potentially increase total costs significantly. Moreover, the impacts might differentially impact certain populations. For example, there is evidence that the Blacks were nearly twice as likely to be victims of fraud as White consumers, and Hispanics had a 50% higher rate (Anderson, 2013). Thus, data on both the incidence and costs of nonmonetary harms would significantly improve upon the application of benefit-cost analyses.

While it might not be feasible to conduct studies of these harms for every regulatory or policy decision, it is possible to estimate the public’s willingness-to-pay to reduce the potential harm from fraudulent activity more generally. Rigorous methodologies have been developed over the years for estimating the monetary value of everything from health impacts, risk of death, as well as environmental amenities – often called ‘contingent valuation’ methods. There have been literally hundreds of such studies, meta-analyses and textbooks written on the subject (see e.g., Kling, Phaneuf, & Zhao, 2012; Mitchell & Carson, 1989). Although there is some disagreement on the reliability of these surveys, they are continually being used in benefit-cost analyses, natural resource damages litigation, and for other purposes. A distinguished panel of social scientists, chaired by two Nobel laureates in economics (Arrow et al., 1993) was commissioned by the National Oceanic and Atmospheric Administration (NOAA) to assess the contingent valuation methodology. The panel concluded that this is a valid approach and provided a set of guidelines for conducting a reliable contingent valuation survey. These methodologies have also been adopted and relied upon in regulatory impact analyses outside the environmental and health context by agencies such as the Department of Transportation, the Consumer Product Safety Commission and the

² Much of this section is based on Chapter 10 of my recent book (Cohen, 2020), which contains additional examples and citations.

Department of Justice. Moreover, the Office of Management and Budget has recognized the efficacy of these approaches and recommended their use in regulatory impact analyses (Office of Management and Budget, 2003, 2011).

The state-of-the-art methodology for eliciting the public's willingness-to-pay has developed considerably since the NOAA panel's report in 1993. Realizing that it is not easy to think about how much you are willing to pay to reduce risk, a similar methodology, "discrete choice experiment," (DCE) is now more commonly used to value environmental amenities and has recently been used to value crime (Picasso & Cohen, 2019). Instead of eliciting a dollar valuation, DCE provides respondents with two or more alternative "bundles" and asks them to rank them. By including a "price" (either through a voluntary contribution or a tax) in the description of the bundle, researchers can infer the marginal willingness to pay for different components of the bundle (Louviere, Hensher, & Swait, 2000). This is a more realistic setting than asking directly for a valuation of a nonmarket amenity such as pollution, crime, or fraud reduction – and instead, by focusing on trade-offs and choices of bundles of good, it is much easier for respondents to relate to in their daily decisions without having to explicitly provide a dollar valuation.

The Department of Justice example is probably most relevant to the CFPB because it is also a law enforcement agency. In 2012, the U.S. Department of Justice issued the final Regulatory Impact Assessment (RIA) of the Prison Rape Elimination Act (PREA) – the first ever RIA of a criminal justice rule. Following OMB guidance on conducting a benefit-cost analysis when possible (Executive Order 12291, 1981), the RIA supporting the implementation of the PREA regulations was based on estimates of the cost of a rape, which ranged between \$200,000 and \$300,000 and included estimates based on willingness-to-pay. These estimates were dominated by the intangible costs of rape, compared to the tangible out-of-pocket costs that are often only a few hundred or thousand dollars (Cohen, Rust, Steen, & Tidd, 2004; Miller, Cohen, & Wiersema, 1996). DOJ indicated that this regulation would never have passed a benefit-cost test if they relied solely on monetary costs and benefits (U.S. Department of Justice, 2012). Moreover, they indicated that no objections were raised during the public comment period to their use of intangible cost of crime estimates.

To date, there have only been a handful of willingness-to-pay studies estimating the cost of consumer fraud. In one study, I estimated the public's willingness-to-pay for reduced identity theft victimizations – with intangible victim costs ranging between \$134 and \$2,450 in 2007 dollars (Piquero, Cohen, & Piquero, 2010). In another study, I estimated the willingness-to-pay to reduce the risk of financial fraud to be \$12,000 in 2011 compared to the FTC's estimated average monetary victim loss of \$200 to \$250 (Cohen, 2015). Are these intangible cost estimates credible? Admittedly, they are based only on two studies - although they are both published in peer reviewed journals. They are also consistent with anecdotal evidence on the extent to which victims of identity theft and fraud may suffer from severe psychological harm in addition to collateral consequences such as losing a home, reduced health care outcomes, etc. (see Cohen, 2020: Chapter 11 for a more detailed discussion of the cost of white collar and corporate fraud). The bottom line is that data on the intangible costs of financial frauds that are likely to be under the CFPB purview is greatly needed if benefit-cost analyses are to have any potential validity.

In the context of discrimination – ask a Black borrower who paid more for credit than they otherwise would have if they were White – whether the "cost" to them from discrimination was equal to the higher interest rate. Instead, I would argue that there is considerable "indignation" or "humiliation" cost from discrimination, and that this can be quantified using the techniques I mentioned above. I have

proposed this in a paper focused on targeting policing (Cohen, 2017) and a similar approach could be applied to lending discrimination. Studies quantifying the intangible costs of discrimination would significantly improve the ability of benefit-cost analysis to inform policy makers on the extent to which resources should be devoted to reduce discrimination.

Models

As suggested in my comments above, the appropriate way to think about consumer protection is from an *ex ante* risk perspective. Consumers considering a proposed financial transaction with an uncertain outcome are faced with some risk that they will not understand the contract provisions, will be fraudulently sold a product they did not want, etc. The preferred approach to conduct benefit-cost analysis when confronted with uncertain outcomes is to focus on the expected net benefits of regulation (see e.g., Chapter 8 of Boardman, Greenberg, Vining, & Weimer, 2011). Thus, the value to consumers from reduced fraud should be based on their willingness-to-pay to reduce the risk of being a fraud victim. There is a growing literature that develops benefit-cost models further when there is considerable uncertainty and Alex Lee, who is the first speaker on this panel, spoke about this issue in some detail.

I would also note that one of the benefits of using a willingness-to-pay model in thinking about *ex ante* risk is that the benefits from consumer regulation then accrue not only to the ultimate victim but to potential victims as well. Just as we all benefit from a safer neighborhood and lower fear of crime, when consumers are protected from mortgage fraud or servicing errors, for example, we all benefit from less fear of victimization or harm, an expectation that our neighborhood property values will not be diminished from widespread foreclosures, etc. Even if there is no direct *ex ante* value to the non-victimized public, there might even be what economists call ‘non-use’ value – i.e., I might place value on living in a society where fewer consumers are harmed or discriminated against even if I have no direct risk of ever being in such a position. Of course, this model is only as good as survey respondent ability to comprehend the questions and potential impact of victimization – i.e., respondents need to be able know what to value.

This approach might also be used to improve our understanding of the benefit of reducing discrimination in lending markets, for example. To the extent non-minority members of the public value living in a society that is free from racial or ethnic bias in lending markets, for example, they might be willing to pay some amount to live in such as society. Hence, these type models might provide powerful new evidence on the cost of discrimination.

Distributional Concerns

Although the CFPB may bring enforcement actions based on discrimination, even outside the enforcement context CFPB regulatory and guidance activities may impact certain populations differentially. For example, as noted above, there is evidence that the Blacks are nearly twice as likely to be victims of consumer fraud as White consumers, and Hispanics had a 50% higher rate (Anderson, 2013). Thus, data on both the incidence and costs of nonmonetary harms would significantly improve upon the application of benefit-cost analyses.

Benefit-cost analysis can handle distributional concerns in several ways. While I do not intend to survey this literature, the interested reader is once again pointed to any of the leading benefit-cost textbooks.

Suffice it to say that considering distributional issues is critical to any benefit-cost analysis – either formally in the model or as part of an additional assessment. The latter is commonly done – however, it runs the risk of considerable subjectivity and politicization of the analysis. A recent article in the New York Times highlights the problem in the context of local flood protection expenditures (Flavelle, 2020). If the goal is to reduce the expected value of property losses, government funded flood protection will go to the wealthiest communities. However, a more nuanced - and I would argue sophisticated analysis might lead to a different conclusion by considering distributional concerns, vulnerability, and the ability of wealthier neighborhoods to self-protect and/or insure.

The same issue has come up in the context of traditional street crime. For example, even ignoring any intangible costs, an argument that has been made against benefit-cost analysis is that holding government program costs constant, a policy that reduces auto thefts of \$50,000 cars would be favored over one that reduced theft of old, inexpensive vehicles – thereby resulting in higher net benefits albeit to the benefit of the wealthy. The problem with this argument is that economic theory would suggest policies should be focused on the least cost avoider (see e.g., Cohen, 2020: 207-9). Moreover, it is not clear that the government is necessarily the least cost avoider – especially when it comes to protecting property of the wealthy. Similarly, if the CFPB were to focus on protecting the accredited investor at the expense of first-time borrowers with few assets, while the total monetary benefit of such a policy might be greater, this ignores the fact that the accredited investor with \$5 million in assets is probably in a better position to afford to take costly actions to avoid fraudulent activity, while the cost of fraud protection to the novice is likely to be much higher as a percent of her assets. However, it is not just the least cost avoider principle that might tilt the balance in favor of the low-income consumer. In particular, the cost of fraud is often much more than the dollar loss itself. This point was made above when I argued that there may be both significant intangible and nonmonetary costs associated with fraud.

Benefit-cost analyses in the criminal justice arena have dealt with distributional consequences of policy choice by explicitly ignoring the income of the typical crime victim and instead focusing on either the public's *ex ante* willingness-to-pay for crime reduction or the *ex post* harm based on average (not victim) valuations (see e.g., Cohen, 2020: 171-2). For example, despite the fact that crime victims are likely to have had below average earnings and perhaps below average willingness-to-pay valuations, benefit-cost analyses of crime policies have instead used average valuations based on the population as a whole. Thus, to the extent victims are likely to be on the low end of the income distribution, they are actually advantaged by the assumptions used in benefit-cost analyses. Of course, the use of these average valuations is an explicit policy choice and one could instead conduct a benefit-cost analysis that used lower benefit numbers.

Incentivizing Research

There are many ways to incentivize academic research including hosting workshops on special topics. However, an important way in which government agencies can incentivize research is to make data available to and/or conduct collaborative research with academic researchers. Oftentimes this is done through summer, semester, or year-long fellowships, post-docs, or simply by hosting regular academic speakers to present their research and interact with staff. If a small amount of funding is available, another approach would be to host competitive grant proposals for the secondary use of bureau data. Even a few thousand dollars awarded through a competitive process can generate many good ideas by

junior faculty looking to fund a research assistant and the prestige of receiving a competitive grant. For many years, the Bureau of Justice Statistics used this approach to fund small grants through the American Statistical Association's Committee on Law and Justice Statistics. These awards were quite successful in attracting new researchers to the criminal justice arena. They also allowed for the continued leverage of older datasets that might otherwise have languished.

Unfortunately, conducting well designed, nationally representative studies of the type I have suggested requires significant resources. Conducting a contingent valuation survey or discrete choice experiment with an adequate sample is likely to cost hundreds of thousands of dollars. Nevertheless, it is important to realize that these studies are not necessarily of value only once and for one regulatory analysis. Instead, since they are often valuing more generic forms of harm, estimating monetary harms once can be used multiple times in different contexts. If funding is limited, it is also possible to leverage other studies outside the consumer protection area. For example, a recent willingness-to-pay survey that I conducted in the criminal justice arena (and funded by the National Institute of Justice) included questions focused on consumer fraud – which was not even defined as being criminal to survey respondents (Galvin, Loughran, Simpson, & Cohen, 2018; Simpson, Cohen, & Loughran, 2015). As noted above, BJS conducts regular victimization surveys of the public that include identity theft as one potential area of victimization. One could imagine expanding the scope of their survey to elicit related information on other consumer frauds. Even when another agency is not focused on the same policy question, there may be opportunities to leverage and economize on the large fixed costs of conducting a study. For example, many years ago, a study I was conducting with funding from the National Institute of Justice to study the cost of crime was supplemented with a small amount added at the request of the U.S. Sentencing Commission to increase the scope to include several questions about sentencing preferences. Given the similarity and potential overlap in fraud jurisdiction across agencies including the FTC, SEC, DOJ, and CFPB, this type leveraging might be a viable path going forward.

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