

# Taskforce on Federal Consumer Financial Law Report

Volume I



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a. This report was produced in violation of the Federal Advisory Committee Act (“FACA”). As a task force established and utilized by the Bureau in the interest of obtaining advice or recommendations, the Taskforce on Federal Financial Consumer Law was an advisory committee subject to FACA. 5 U.S.C. App. 2 § 3(2). Among other things, FACA required the Bureau to:

i. Consult with the General Services Administration (“GSA”) prior to chartering the Taskforce regarding why the Taskforce was essential to the conduct of the Bureau’s business and why the Taskforce’s functions could not be performed by other means, 5 U.S.C. App. 2 § 9(a)(2); 41 C.F.R. § 102-3.60;

ii. Describe to the GSA the Bureau’s plan to attain a Taskforce membership that was fairly balanced in terms of the points of view represented and the functions to be performed by the Taskforce, *id.*;

iii. Determine as a matter of formal record—after consultation with the GSA and before chartering the Taskforce—that the Taskforce was in the public interest in connection with the performance of the Bureau’s duties, 5 U.S.C. App. 2 § 9(a);

iv. Ensure that the Taskforce membership was fairly balanced in the manner described above, 5 U.S.C. App. 2 § 5(b)(2), (c);

v. Hold the Taskforce’s meetings open to the public, 5 U.S.C. App. 2 § 10(a)(1); and

vi. Make the Taskforce’s records available for public inspection, *id.* § 10(a)(3)(b).

b. Because none of these requirements were met, the Taskforce was created and operated in violation of FACA. For the same reason, this report was produced in violation of FACA.

c. Accordingly, the Bureau advises that this report should not be relied on as the product of a federal advisory committee that was established or operated in compliance with FACA. Adhering to FACA’s requirements “ensure[s] that advisory committees are fairly constituted and properly monitored so that they will provide sound advice.” *Cummock v. Gore*, 180 F.3d 282, 291 (D.C. Cir. 1999). Because the Taskforce did not comply with FACA’s requirements, readers should not assume that the report provides “sound advice.”





# About this report

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# Message from the Director

I am pleased to share the Consumer Financial Protection Bureau's Taskforce on Federal Consumer Financial Protection (Taskforce) report. This has been one of my top priorities as Director of the Bureau, and I have been as eager to read the final product as many in the public, because this report offers recommendations and insights to meaningfully improve consumer protections, the financial marketplace, and the lives of consumers and providers of financial products and services.



The Taskforce was, in part, inspired by one of the last times the federal government stepped back to take a comprehensive look at the full, interwoven regime of consumer protection and financial laws and regulations. In 1968 the landmark Consumer Credit Protection Act was passed, which among its terms established the National Commission on Consumer Finance (NCCF). The NCCF was chartered to conduct original research and provide recommendations relating to the regulation of consumer credit. The report led to significant legislative and regulatory developments in consumer finance. Since the publication of that report nearly 50 years ago, a lot has happened. Decades of advancements and innovations have occurred in technology and the financial services industry – and the federal government, as well as the states, have worked in piecemeal to try to address the rapidly evolving landscape. Additionally, the legislative branch has modified statutes, which has created some overlapping jurisdictions between federal regulators as well as state entities. Even the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) was passed, which created a whole new Consumer Financial Protection Bureau!

The world of consumer finance had changed dramatically in the last 50 years. DFA states that the purpose of the Bureau is “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.” This is a big mandate and fulfilling our statutory obligations has taken a lot of work. July 2020 marked the 10<sup>th</sup> anniversary of the DFA. Thanks to the hard work, dedication, and commitment of the Bureau's incredible staff and my predecessors, the Bureau is past the startup phase of establishing a new federal agency and is approaching the completion of our statutorily required rulemaking. Therefore, now was the right time to take a step back and holistically evaluate how to fulfill our objectives and functions in a more effective and efficient manner.

This opportunity, the Taskforce's work, was important enough to ensure the project continued despite a global pandemic. It was so important that, even before the pandemic hit, I established a team focused entirely on the effort so that the agency could continue to focus on nearer-term

tasks and my agenda to carry out our critical mission as well as maintain our daily operations. We were lucky to have put together such a strong and capable group of public servants.

During my first meeting with the Taskforce, I directed the Members to consider not just the work done since the Bureau was created but also to use lessons from history of consumer financial regulation to help us prepare for the next ten-to-twenty years. So, like the NCCF, I instructed the Taskforce Members to develop a set of recommendations that should project into the future on what the state of consumer finance will look like. Each recommendation was to have strong arguments, supported by research and deliberations of alternative considerations. The Taskforce recommendations were developed as independent from current Bureau stances or influences on how we have always done business. Recommendations were to take the form of referrals to Congress for legislative action, suggestions for changes to existing regulations, writing of new regulations, ideas for new systems of coordination between federal regulators, promotion of new federal-state working relationships, or identification of subjects in need of further research. All recommendations required unanimous agreement amongst the Members.

With the public release of this report, I will highlight a number of Taskforce recommendations for Bureau action. The decision to focus on some recommendations at the current time but not others reflects priorities and ease of implementation, as well as recognition that some recommendations will require greater buy-in and further consideration. Release of this report is definitely not the end, but rather just the beginning for implementing recommendations that will help ensure “all consumers have access to markets for consumer financial products and services” and to help keep “markets for consumer financial products and serves fair, transparent, and competitive.”

Kathleen Kraninger  
Director, Bureau of Consumer Financial Protection

# Message from the Taskforce

The Consumer Financial Protection Bureau Taskforce on Federal Consumer Financial Law (Taskforce) is pleased to present you with this final Report as Director of the Consumer Financial Protection Bureau (Bureau).

As provided in the Taskforce Charter, you requested that we “provide an objective and independent evaluation, in the form of one consensus final report to the Director, of the Bureau’s current regulatory framework,” to “examine the existing legal and regulatory environment facing consumers and financial services providers,” and to “report its recommendations for ways to improve and strengthen consumer financial laws and regulations.” Finally, as required by our Charter, we have delivered our final Report by January 2021. We hope to have succeeded in meeting the goals and expectations in establishing the Taskforce.

The Report was researched and authored by five Members, one of whom served as Chair of the Taskforce; and six support staff, overseen by a Staff Director. As requested, this Report reflects the consensus views of the Taskforce Members. Moreover, given the nature of the Taskforce, the views espoused in the Report may not represent current Bureau positions or policy.

To fulfill the scope of our charter, the Taskforce has published a two-volume report. Volume I contains references to original empirical data, information, and analyses, and can be broken into three sections:

1. A historical and economic overview of consumer finance;
2. The framework of consumer financial protection: consumer protection, competition, innovation, and inclusion; and
3. Modernizing the regulatory framework and expanding consumer empowerment.

We used the insights gained to develop Volume II, which contains recommendations. Our recommendations seek to improve the lives of every American consumer, regardless of race, creed, gender, ability, or status, with the important focus on improving access, inclusion, and choice for all Americans.

Each member brought unique experiences and views and is impressively accomplished, well respected, and immensely capable in the field of consumer financial protection and Federal consumer financial law. To fulfill the Taskforce mandate, the Members leveraged their combined 150 years of professional experience as well as the extensive expertise that exists within and outside of the Bureau. The Taskforce is especially grateful for the tireless and

valuable contributions of Taskforce support staff, who were encouraged to contribute their personal experiences and professional expertise to the conversation. The final Report was improved immensely by their contribution to the Taskforce deliberations and production. The Members, however, own all responsibility for the final analysis and recommendations in the Report.

Every American has a stake in a fair, efficient, and modern system of consumer finance. As such, tremendous effort was taken to ensure the great diversity of the American consumers' views, opinions, and experiences were given voice. To achieve this end, a particular objective of the Taskforce was to seek as much valuable public input as possible, a goal that immediately became challenging as a result of the onset of the global health pandemic just weeks after the Taskforce began its deliberations.

Despite these challenges, the Taskforce redoubled its efforts to seek public contribution through written comments and virtual engagements with stakeholders inside and outside the government, information which is included throughout the final Report. Indeed, writing the report in real time as consumers and regulators rose to the challenge of responding to the pandemic and its economic effects constantly reminded the Taskforce of the importance of protecting and empowering consumers as well as ensuring a modern and resilient consumer financial protection framework that can swiftly respond to the needs of America's consumers. The Taskforce issued a Request for Information; conducted a robust public research effort; met with trade, consumer advocates, academics, and the Bureau's advisory committees in meetings listened to by hundreds of public observers; and conducted over twelve intergovernmental engagements with partner state and federal regulators to hear as many perspectives as possible. Economic analyses and empirical research are the foundation of this report, and it advocates for the interest of only one stakeholder – the consumer.

Finally, the Taskforce Members and staff would like to express our appreciation to you for trusting us with this charge to recommend ways to improve the operation of the nation's system of consumer financial law. We also would like to recognize and express our appreciation to all the Bureau staff who assisted the Taskforce throughout the research and writing of the Report. The Bureau staff engaged in open dialogue and demonstrated their deep commitment to improving the consumer financial regulatory system and the lives of American consumers. The Taskforce would like to especially thank Deputy Director Brian Johnson, Acting Deputy Director Leonard Chanin, and Deputy Director Tom Pahl for their support of the Taskforce and its mission.

In the decade since it was formed from the ashes of the 2008 financial crisis, the Bureau has grown from a startup to a powerful champion for the American consumer. As part of its deliberations, the Taskforce surveyed the Bureau's activities in the ten years since its founding. The Appendix to the Foreword of Volume I of this report provides a summary of some of the

major accomplishments. The list is impressive and wide-ranging, covering all the Bureau's tools and functions. The Taskforce is honored to be part of this legacy and to contribute to the Bureau's continued success.

Respectfully,

Todd J. Zywicki, J.D.  
Taskforce Chair

J. Howard Beales, Ph.D.  
Taskforce Member

Thomas A. Durkin, Ph.D.  
Taskforce Member

William C. MacLeod, J.D.  
Taskforce Member

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# Foreword

One hundred years ago marked the dawn of the modern American consumer financial system, as increasing urbanization and the emergence of a wage economy led the Russell Sage Foundation to call for national efforts to erect a new regulatory framework that would better meet the needs of American workers. Fifty years ago, the National Commission on Consumer Finance (NCCF) was convened in response to the emerging national structure of consumer financial markets and the growing need for a larger federal regulatory presence to address those challenges. Today, as revolutions in technology, the economy, and consumer preferences raise new opportunities and threats for American consumers, it is a propitious time to once again review the framework of consumer financial protection.

The Taskforce firmly believes that robust federal enforcement is essential to effective consumer protection. Markets are important and cannot be ignored in the effort to maximize consumer welfare as judged by consumers. But, as recognized in the previous assessments, markets are not enough. Government has a crucial role to play in ensuring that the financial system delivers products and services that are fairly priced, with reasonable terms, and available to all consumers.

The Report is organized in two volumes. Volume I provides a historical and economic overview of consumer finance, covers the key principles that form the core of federal consumer financial law and policy, and discusses particular topics that are important to the Bureau's work. Volume II develops recommendations to improve and strengthen the application of financial laws and regulations. Recommendations are grouped in alphabetically listed topics.

In drafting the Report, the Taskforce has been animated by three overarching principles. First, consumer protection policy should be particularly attentive to the consequences for inclusion and access by those communities that have previously been underserved. Toward that end, an essential element of policy should be to facilitate competition, innovation, and consumer choice in the marketplace. Second, consumer financial protection policy should be focused on avoiding harms to consumers rather than attempting to specify how providers should design and market their products. Third, the existing regulatory framework needs modernization to enable it to adapt more nimbly to changes in technology and consumer preferences, respond to new opportunities and threats to consumers, and address future crises, such as the 2008 financial crisis that spawned calls for the Bureau's creation and the 2020 Coronavirus pandemic.

The report is organized around the key areas of analysis of consumer protection: the legal framework of consumer protection, information and disclosure, competition and innovation, inclusion and access, and regulatory modernization.

First, in analyzing the legal framework of consumer protection, the report focuses on implementing the goal of minimizing consumer harm through effective regulatory policies that protect consumers, promote the fair and efficient operation of markets for the benefit of consumers; and the report identifies the optimal use of the five regulatory tools available to the Bureau in executing its duties (enforcement, regulation, supervision, financial education, and policy research and development). The report also recommends the Bureau reorganize around the markets it regulates rather, than the tools it implements with an eye toward efficiently minimizing consumer harm.

Second, the report identifies the role of consumer information and disclosures in promoting consumer protection and welfare. Since the enactment of the Truth-In-Lending Act, disclosure and information provision to consumers has been a primary focus of the consumer financial protection system. Today, however, consumers are overwhelmed by a blizzard of information and disclosures, which are often required for a variety of different and often contradictory purposes. The Taskforce believes that policymakers should review the current disclosure regime to focus shopping-related disclosures on the central goal of promoting informed choice by consumers. Disclosure policy should be reviewed and modernized, where appropriate, to facilitate electronic disclosures aimed at providing consumers with the relevant information needed at the moment of decision. Finally, the report also stresses that although information can be useful to promote consumer choice and competition, it is equally important that policymakers be cognizant of the limits of consumer attention and that *pro forma* notice and consent by consumers should not be a substitute for agency action to protect consumers from harm.

Third, the Taskforce emphasizes that an essential organizing structure of the consumer financial system should be an emphasis on competition, innovation, and consumer choice. Since the NCCF report fifty years ago, the development of the consumer financial system has contributed to widespread prosperity, autonomy, and material comfort. Competition and innovation have produced lower prices, greater variety, and expanded choice, putting bank accounts and credit cards within reach for millions of consumers for the first time in American history. To facilitate competition and innovation, the Taskforce recommends enabling non-bank institutions to provide a greater array of financial services, including authorizing nonbank payment systems, reducing regulatory obstacles to chartering of industrial loan companies, and expanding the opportunities for credit unions to serve low-income communities. Finally, the Taskforce recommends that the CFPB be authorized to grant charters to non-depository FinTech companies, payments processors, and other financial service providers that operate in inherently interstate markets.

Fourth, the Taskforce believes that increasing financial inclusion and access to products and services on fair and reasonable terms is a moral imperative and should be a central focus of

consumer financial regulatory policy. Although the innovations and developments of recent decades have brought quality financial services at competitive prices to middle class consumers, some consumers remain on the margins of the system, including those who are “credit invisible” or lack the resources or knowledge to navigate the consumer financial system successfully. A first step toward promoting greater inclusion involves continued vigilance to attack barriers to inclusion based on characteristics such as race or sex, but policymakers should consider expanding those protections to other characteristics, such as disability. The Taskforce also believes that policymakers should consciously adopt policies that will facilitate greater inclusion, such as creating a modern regulatory framework for FinTech firms, facilitating use of alternative data, allowing greater use of industrial banking charters for commercial providers of financial services, and adopting a faster payments clearing system. In addition, the Taskforce also recommends that policymakers reconsider existing laws and regulations that adversely affect financial inclusion, such as price controls on debit card interchange fees at larger banks, that interfere with the ability of credit card issuers to adjust terms when a consumer’s risk profile changes, and that impede offering cards to consumers who currently have difficulty accessing credit.

Finally, the onset of the Coronavirus pandemic contemporaneously with the Taskforce’s deliberations has highlighted the urgent need for a flexible, nimble, and adaptive consumer financial protection system. Innovation and technical change have always been drivers of reform in consumer financial protection law. For example, the declining cost of long-distance telephone calls, the growth of national department stores and credit-granting practices, and the increase of interstate mobility of consumers in the post-World War II era created the need for a larger federal role in consumer financial protection beginning in the 1960s. Today, the pace of change in technology and consumer preferences has accelerated, putting even greater pressure on the need for adaptability to protect consumers from rapidly emerging threats to their privacy, data security, and financial well-being. In addition, this rapidly emerging environment places an enhanced premium on the need for consumers to have the tools of financial knowledge and literacy to take advantage of these innovations when appropriate. Although unprecedented in its nature, the Coronavirus pandemic has illustrated the need for a financial system that is resilient enough to respond nimbly to emergent crises through the design of its institutions and content. The report recommends that to promote a more responsive regulatory structure, financial regulators should make greater use of principles-based regulation, consider the efficient mix of the Bureau’s regulatory tools, and establish authorities and procedures for responding to crises in a predictable fashion.

Some important sectors and topics are not addressed at length in the report. The Members used a three-pronged test to help determine the scope of the report: (1) was a sector or subject already substantially and adequately addressed by recent activity by the Bureau or some other source, (2) did the Members possess a comparative advantage in offering insights or was it beyond the

scope of expertise or the Taskforce’s charter, and (3) did the Taskforce have something meaningful or constructive to contribute to identifying important problems and possible solutions? For example, mortgages and mortgage service providers are hugely important topics for consumers and the economy; nevertheless, they are only covered tangentially given the recent and extensive modernization efforts the Bureau has undertaken since its inception, as noted in Appendix A to this Foreword. Due to the time-limited nature of the Taskforce’s work, numerous recommendations suggest further research and deliberation before developing a position. The importance of topics should not be measured by the number of pages or recommendations devoted to them, and the potential for improving consumer financial protection should remain a perennial subject of reexamination.

This report seeks to make the complex subjects of law, economics, and consumer financial protection approachable and easy to understand. Readers will notice that the background and recommendations are written in plain language while scholarly studies, analyses, and denser material can be found in footnotes and references. Policy makers should consider the report in totality, but other readers will not be lost should they choose to review a single chapter or section. Important themes are repeated to help accomplish this goal.

The research and analysis presented in Volume I is a framework for thinking about consumer financial protection law and economics. It is intended to lay a foundation of knowledge and principles to which policymakers, Bureau employees, and the public can return as new issues in consumer finance and financial protection arise. It may also serve as foundational thinking or guiding principles for future Bureau actions (rule makings, supervisions or enforcement actions, assessments, research, policy guidance, consumer education, et cetera).

Volume II is more pragmatic and temporal in nature. The recommendations are being made at a point in time. Government executives, policy makers, and their staff should consider how the current financial regulatory regime and framework has evolved when viewing these recommendations in the future.

The members of the Taskforce are grateful for the opportunity that we have been provided to undertake this report on behalf of the American people. The insights of the NCCF’s report fifty years ago shaped consumer financial protection policy for decades to come—indeed, the NCCF report called for the creation of a consumer financial protection regulator much like the one that later became the CFPB. As the Bureau celebrates its 10<sup>th</sup> Anniversary and looks forward to the next fifty years, the Taskforce hopes that our contributions may prove equally long lasting.

## FOREWORD, APPENDIX A:

# Bureau highlights: A 10-year review

The Taskforce wanted to note that the Bureau has had significant success since its start nearly ten years ago. Through the lens of the tools granted to the Bureau by Congress (enforcement, rulemaking, supervision, research, education) this appendix highlights a (non-exhaustive) list of those successes.

## Enforcement

- Since its founding, Bureau public enforcement actions have resulted in over \$12.9 billion in total consumer relief (over \$5.8 billion in consumer redress and over \$7.1 billion in other relief) and over \$1.5 billion in civil money penalties, before adjusting for suspended amounts.<sup>1</sup>
- So far in 2020, the Bureau announced 42 public enforcement actions, settling 3 previously filed lawsuits and actions ordering nearly \$670 million in total consumer relief and over \$90 million in civil money penalties, before adjusting for suspended amounts.
- Enforcement actions have been taken to address law violations in connection with consumer financial products and services. These actions targeted Bureau-regulated banks, loan servicers, debt collectors as well as entities in the fair lending arena. Through enforcement, the Bureau has also sought to protect servicemembers and students from deceptive practices.<sup>2</sup>
- Through the Bureau's Office of Innovation, the Bureau has promoted innovation in markets for consumer financial products and services. The office has created a streamlined No-Action Letter (NAL) application process, resulting in nine approved

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<sup>1</sup> Consumer Financial Protection Bureau, *Payments to Harmed Consumers* (Dec. 2020) (<https://www.consumerfinance.gov/enforcement/payments-harmed-consumers/>)

<sup>2</sup> Consumer Financial Protection Bureau, *Rules Policy* (n.d.) (<https://www.consumerfinance.gov/rules-policy/>)



NAL's or NAL templates since 2019.<sup>3</sup> These letters have helped bring regulatory certainty to the marketplace.

- The Office of Innovation has also helped bring together technologists with financial, consumer, and regulatory stakeholders at Tech Sprints.<sup>4</sup> These events are dedicated to creating technology-focused solutions to a variety of regulatory and consumer protection challenges. The first Tech Sprint was held in October 2020, with teams focused on developing new approaches to electronically delivered adverse action notices.
- The CFPB's Office of Fair Lending has worked to make financial products and services more accessible to consumers who are unbanked and underbanked, including those who are Limited English Proficient (LEP). The office has also advocated the use of alternative data in underwriting, seeking to expand fair, equitable, and nondiscriminatory access to credit.<sup>5</sup>

## Rulemaking

- Part of the Bureau's role is to implement and enforce consumer financial laws. Since 2012, the Bureau has finalized dozens of rules ensuring all consumers have access to markets for consumer financial products and services that are fair, transparent, and competitive. The rulemaking process receives substantial public input from all stakeholders before the rule is finalized.<sup>6</sup>
- Finalized rules have focused on establishing clear rules of the road for financial institutions and consumers alike. These rules have helped define and clarify federal consumer financial law in areas such as payday lending, debt collection and mortgage lending.

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<sup>3</sup> Consumer Financial Protection Bureau, *Granted Innovation Applications* (n.d.) (<https://www.consumerfinance.gov/rules-policy/innovation/granted-applications/>)

<sup>4</sup> Consumer Financial Protection Bureau, *CFPB Tech Sprints* (n.d.) (<https://www.consumerfinance.gov/rules-policy/innovation/cfpb-tech-sprints/>)

<sup>5</sup> Office of Fair Lending, 2019 *CFPB Fair Lending Report* (April 2020) ([https://files.consumerfinance.gov/f/documents/cfpb\\_2019-fair-lending\\_report.pdf](https://files.consumerfinance.gov/f/documents/cfpb_2019-fair-lending_report.pdf))

<sup>6</sup> Consumer Financial Protection Bureau, *Final Rules* (n.d.) (<https://www.consumerfinance.gov/rules-policy/final-rules/>)

- The Bureau has also become a coordinating member of the Global Financial Innovation Network (GFIN), a world-wide effort to promote financial innovation that benefits consumers.<sup>7</sup>

## Supervision

- Hundreds of commissioned Bureau examiners supervise banks, thrifts and credit unions with assets over \$10 billion to ensure compliance with federal consumer financial laws.<sup>8</sup> The Bureau also has supervisory authority over nonbank mortgage originators and servicers, payday lenders, and private student lenders of all sizes.
- The Bureau releases Supervisory Highlights throughout the year to share key examination findings which help the industry limit risks to consumers and ensure compliance with federal consumer financial law.<sup>9</sup>
- The Bureau has provided Advisory Opinions and supervisory guidance to advise and assist regulated entities to better understand their legal and regulatory obligations.<sup>10</sup> Advisory opinions on earned wage access, private education loans and special purpose credit programs have helped promote regulatory certainty.

## Research

- Using data collected from consumer complaints and regulated entities, the Bureau has conducted research and published reports on important topics including consumer credit trends, mortgage delinquency rates and the overall financial wellbeing of consumers.<sup>11</sup> These reports and research have been cited in hundreds of publications.

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<sup>7</sup> Consumer Financial Protection Bureau, *The CFPB and the Global Financial Innovation Network* (n.d.) (<https://www.consumerfinance.gov/rules-policy/innovation/global-financial-innovation-network>)

<sup>8</sup> Consumer Financial Protection Bureau, *Institutions, Supervisory Examinations* (n.d.) (<https://www.consumerfinance.gov/compliance/supervision-examinations/institutions/>)

<sup>9</sup> Consumer Financial Protection Bureau, *Supervisory Highlights* (n.d.) (<https://www.consumerfinance.gov/compliance/supervisory-highlights/>)

<sup>10</sup> Consumer Financial Protection Bureau, *Advisory Opinion Program* (n.d.) (<https://www.consumerfinance.gov/compliance/advisory-opinion-program/>)

<sup>11</sup> Consumer Financial Protection Bureau, *Data & Research* (n.d.) (<https://www.consumerfinance.gov/data-research/research-reports/>)

- The Office of Research has completed five-year retrospectives on Bureau rules to examine their impact and provide recommendations. Assessments have been conducted on TRID, Ability to Repay/QM and remittance rules.<sup>12</sup>

## Education

- Ask CFPB has received over 13 million unique visitors since its launch in 2012, answering hundreds of unique consumer questions.<sup>13</sup>
- The Bureau has handled more than 2.5 million consumer complaints since 2011<sup>14</sup>. More than 5,000 financial companies have responded through this process, providing timely responses to 97 percent of the more than 1.6 million complaints sent to them for response.
- During the COVID-19 pandemic, the Bureau handled tens of thousands of consumer complaints, helped set up an interagency housing assistance page, and created over 70 COVID-19 specific resources for the public to view on its website which were viewed by more than four million users.<sup>15</sup>
- The Bureau has established a consumer complaint database for the public to view this complaint data, with a new Trends view that allows users to sort and filter data. The Bureau has also created partnerships with the Federal Housing Finance Agency and the Department of Education to share this data to help draw conclusions about borrowing.<sup>15</sup>
- The Bureau, through initiatives such as *Your Money, Your Goals* and *Smart Small, Save Up*, has created innovative new tools that help consumers navigate financial decisions involving loans, savings, taxes and more.<sup>16</sup> These resources have helped consumers in vulnerable financial situations such as servicemembers, older Americans, and college students.

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<sup>12</sup> Consumer Financial Protection Bureau, *Kraninger Marks Second Year as Director of the Consumer Financial Protection Bureau* (Dec. 2020) (<https://www.consumerfinance.gov/about-us/newsroom/kraninger-marks-second-year-director-consumer-financial-protection-bureau/>)

<sup>13</sup> Consumer Financial Protection Bureau, *CFPB By the Numbers 2016* (Jan. 2017) ([https://files.consumerfinance.gov/f/documents/201701\\_cfpb\\_CFPB-By-the-Numbers-Factsheet.pdf](https://files.consumerfinance.gov/f/documents/201701_cfpb_CFPB-By-the-Numbers-Factsheet.pdf))

<sup>14</sup> Consumer Financial Protection Bureau, *CFPB Announces New Capability for the Consumer Complaint Database, Expands Ability to View Complaint Data Over Time* (July 2020) (<https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-new-consumer-complaint-database-capability/>)

<sup>15</sup> Consumer Financial Protection Bureau, *Kraninger Marks Second Year as Director of the Consumer Financial Protection Bureau* (Dec. 2020) (<https://www.consumerfinance.gov/about-us/newsroom/kraninger-marks-second-year-director-consumer-financial-protection-bureau/>)

<sup>16</sup> Consumer Financial Protection Bureau, *Consumer Tools* (n.d.) (<https://www.consumerfinance.gov/consumer-tools/>)

- As part of these efforts, the Bureau has distributed hundreds of thousands of copies of educational materials across the United States. The Bureau has trained thousands of professionals in intermediary organizations on how to use these materials and connect with key communities.<sup>18</sup>
- Recent reports have studied HMDA data points to find mortgage trends<sup>17</sup>, and the credit records of young servicemembers and veterans.<sup>18</sup>

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<sup>17</sup> CFPB Office of Research, *Data point: 2019 mortgage market activity and trends* (June 2020) (<https://www.consumerfinance.gov/data-research/research-reports/data-point-2019-mortgage-market-activity-and-trends/>)

<sup>18</sup> CFPB Office of Research, *Data point: Debt and delinquency after military service: A study of the credit records of young veterans in the first year after separation* (Nov. 2020) (<https://www.consumerfinance.gov/data-research/research-reports/debt-and-delinquency-after-military-service-study-credit-records-young-veterans-first-year-after-separation/>)

# 1. Introduction

On October 11, 2019, the Consumer Financial Protection Bureau (CFPB) announced its plan for a Taskforce on Federal Consumer Financial Law. According to the announcement, the Taskforce “will examine the existing legal and regulatory environment facing consumers and financial services providers and report recommendations on ways to improve and strengthen consumer financial laws and regulations to CFPB Director Kathy Kraninger.” The announcement continued:

The Taskforce will produce new research and legal analysis of consumer financial laws in the United States, focusing specifically on harmonizing, modernizing, and updating the enumerated consumer credit laws – and their implementing regulations – and identifying gaps in knowledge that should be addressed through research, ways to improve consumer understanding of markets and products, and potential conflicts or inconsistencies in existing regulations and guidance.

The Taskforce is in part inspired by an earlier commission established by the Consumer Credit Protection Act (Act) in 1968. In addition to various changes to consumer law generally, the Act established a national commission to conduct original research and provide Congress with recommendations relating to the regulation of consumer credit. The commission’s report contains original empirical data, information and analyses – all of which undergird the report’s final recommendations. The data, findings, and recommendations from the commission were all made public, and the report led to significant legislative and regulatory developments in consumer finance.

This announcement raises three immediate questions:

1. what was the earlier commission the announcement cited;
2. what did it recommend; and
3. what is the intent of the new Taskforce in more detail?

# 1.1 The National Commission on Consumer Finance

The earlier commission was the National Commission on Consumer Finance (NCCF or Commission), established by Title IV of the Consumer Credit Protection Act of 1968 to study consumer credit. This was the same Act that established Truth in Lending as Title I. After time spent holding hearings, gathering and analyzing data, and undertaking legal reviews, the NCCF issued its final Report on December 31, 1972 (Consumer Credit in the United States: The Report of the National Commission on Consumer Finance). Well known in its time and widely available in print from the Government Printing Office, the Report is less well known now after almost five decades, but it remains a landmark in the development of consumer credit research and regulation.

The National Commission undertook its review about fifty years after the beginnings of modern consumer credit in the United States. Credit used by individuals is known from antiquity, but newer forms began to develop after the Civil War. 1870 to 1920 can be considered the “premodern” period of domestic consumer-credit development.

This premodern period witnessed a large-scale movement of individuals from rural areas and family farms to growing urban areas. Railroad development improved transportation, which encouraged wider markets and industrialization. Industrialization and urbanization led to a variety of new jobs, both blue-collar and white. This also meant that for the first time in history large numbers of new industrial employees like day laborers, machinists, plumbers, steamfitters, bookkeepers, office workers, retail clerks, and others with small immediate families now lived apart from extended families. Many did not even know their new neighbors, at least not very well. This meant they sometimes had to face various financial needs and emergencies alone without wider support and encouragement. Waves of immigrants during these years found themselves even farther from families still in the old country, often with extremely limited resources to fall back upon.

But these economic changes also encouraged further economic development based more on urban wage-earning than on rural agriculture. Steadier sources of financial income for many families sometimes allowed for some of their income to be pledged for debt repayments. In effect individuals discovered the possibility of converting their main asset, their income from employment, in ways that better met their needs. Credit use could help manage some emergencies among industrial workers, but it also encouraged slow development of a more middle-class lifestyle among upwardly mobile population segments. Sewing machines from the Singer Company, coal stokers, pianos and parlor organs for home entertainment, and factory-built furniture became popular purchases “on time.” Though credit use was frowned upon by many during the Victorian years (especially among wealthier members of society who criticized

social striving and alleged profligacy of the working class and emerging middle class for material goods), credit use continued to increase, nonetheless.<sup>1</sup>

Interest-rate ceilings in all the states at the time made it difficult for potential lenders to provide credit to individuals profitably, so credit sources were limited. Rate ceilings dated to the British legal traditions imported into America during colonial times, although they had been repealed in England by this time. Lenders working outside the law were the common source of cash loans for necessities and emergencies during these years. Some of these lenders were what we might otherwise consider legitimate businesses but operating outside the rate ceilings. The need to operate outside any law does not encourage widespread entry by legitimate businesses though, and so the prevailing market conditions also encouraged entry by less-reputable lenders who sometimes engaged in various sharp practices.<sup>2</sup>

The other common sort of consumer credit during these years involved sale of specific goods with payment accepted over time. Court decisions determined that sellers could charge one price for payment now and a different price for payment later without transaction being considered a loan -- the price difference would be considered a “time-price differential.” Since it was not interest under the law as interpreted by the courts, it was not subject to interest-rate ceilings. Again, although there were many legitimate credit sellers, this situation also sometimes produced failures of transparency and unsavory practices.

Beginning about 1910, reformers began to take aim at the need for changes in provision of consumer credit. Credit used by individuals was still regarded as somewhat disreputable, but better understanding of its benefits. Reform efforts, especially on the cash-lending side, became a goal of the social-reform-oriented Russell Sage Foundation. The Foundation argued for legal and transparent, regulated markets for cash loans rather than illegal lending. Besides introducing systematic study of the consumer-credit phenomenon, it drafted a model reform law

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<sup>1</sup>Cultural aspects of emerging consumer credit use are extensively and ably discussed by Lendol C. Calder in *Financing the American Dream*, referenced in the following footnote.

<sup>2</sup>This premodern period is sometimes called the “loan shark” period of domestic consumer credit. For extended historical review of lenders and lending during these times, see LOUIS N. ROBINSON AND ROLF NUGENT, *THE REGULATION OF THE SMALL LOAN BUSINESS* (New York: Russell Sage Foundation, 1935); IRVING S. MICHELMAN, *CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS* (New York: Augustus M. Kelley, 1970); see also LENDOL C. CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* (Princeton, NJ: Princeton University Press, 1999); ROSA-MARIA GELPI AND FRANCOIS JULIEN-LABRUYERE, *THE HISTORY OF CONSUMER CREDIT* (New York: St. Martin’s, 2000); ELIZABETH ANDERSON, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform, Theory and Society*, 37, 271 (2008); and ANNE FLEMING, *CITY OF DEBTORS* (Cambridge, MA: Harvard University Press, 2018). It is interesting to note that the subtitle of Robinson and Nugent’s 1935 book for the Russell Sage Foundation about overcoming illegal lending indicates how important they thought the reform effort was: “A detailed account of the growth and regulation of a business which is of peculiar importance in our social structure.”

for the states and by 1916 began lobbying effectively for its passage. Eventually, almost all states instituted its recommended reforms in some manner.

Commercial enterprises also saw the advantages of reforms in the credit area. Potential cash lenders looked for a way to enter markets legally and supported the Sage Foundation's reform efforts to eliminate illegal lenders. By 1920, new industries like automobile manufacturers also saw the clear advantage of eliminating abuses in financing so they could sell more output profitably.<sup>3</sup>

These actions among reformers, lenders, manufacturers, and legislators, along with changing societal attitudes toward their efforts in the credit area, supported the beginnings of the "modern period" of consumer credit. Growth of credit for durable goods like automobiles, refrigerators, radios, and others began to be important in the 1920s and 1930s.<sup>4</sup> At the same time, states began systematic revision of rate-ceiling regulations to permit better credit access, although not necessarily consistently across states or even within them.

Consumer credit growth became much more rapid after World War II, with growing prosperity after the war and extensive movement of population to the new suburbs. In addition to substantial economic and consumer credit growth after the war, the period also witnessed further changes in credit regulation at the state level. The first half of the modern period for consumer credit ended with implementation of the first consumer-credit protection law at the federal level (Truth in Lending, effective July 1, 1969) and review of both credit growth and regulation by the NCCF in 1971-2.

In many ways, the Commission and its Report provide both a landmark and a good starting point for the work of the current Taskforce. The NCCF undertook its work just a little over halfway between start of the modern period and the present, about fifty years after early attempts by the Russell Sage Foundation and state legislatures to establish systematic regulation of the new phenomenon of institutional consumer credit. The Commission's work came at the beginning of what we might call the "mature phase" of consumer credit when access to credit became democratized, markets became national rather than local, sometimes technological rather than personal, and regulation became increasingly federal. The following chapters will

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<sup>3</sup>As indicated, under the laws of most states, purchases of specific goods and services with payment over time legally were not loans but were "installment sales" and were regulated differently from loans of money. Consequently, strictly speaking, not all *consumer credit* historically consisted of *consumer loans* and the terms *consumer credit* and *consumer loan* were not interchangeable. For most purposes today, this old legal distinction between "credit" and the narrower term "loan" is no longer relevant and so this report adopts the common modern convention of using the terms *consumer loan* or *consumer lending* interchangeably with *consumer credit*. The Federal Reserve has always included both kinds of credit in its comprehensive statistical series on consumer credit that began in 1943.

<sup>4</sup>See also MARTHA OLNEY, *BUY NOW, PAY LATER: ADVERTISING, CREDIT, AND CONSUMER DURABLES IN THE 1920S* (Chapel Hill, NC: University of North Carolina Press, 1991).



quote liberally from the National Commission's Report from time to time, due to the Commission's key position near this halfway point of modern consumer credit to date and the opportunity to articulate the consistencies in economic and legal thinking on credit topics over time. The overarching goals of both the Commission and this Taskforce are to reexamine how change and pace of change in the consumer-financial area are impacted by the regulatory structure that has developed around them. The Taskforce more than the NCCF also looks at innovation, change, and legal issues in the depository and money-transfer side of consumers' finances.

The Commission's charge from Congress in 1968 was broad, its review and background work was extensive, its establishment of the central questions was thoughtful, and its coverage of the charge and questions was comprehensive at the time. The Report, its footnotes, and the accompanying studies provide a good review of the state of knowledge of consumer credit markets and institutions in the early 1970s. Moreover, through its work, the NCCF established a framework for the development of the next several decades of consumer finance policy and research. Despite occasional discussion over the years of reestablishing a commission or something similar in the consumer financial area, nothing similar has been undertaken until now.<sup>5</sup>

The NCCF developed its analysis and recommendations over 294 pages of the Report and six additional published volumes of technical studies, but its overarching themes for consumer credit markets are easily visible:

- Allow the benefits of credit inclusion to reach all consumers.
- Ensure effective and efficient consumer protection rules and regulations that will maximize consumer welfare.
- Enhance competition in the marketplace encouraging choice.
- Promote consumer sovereignty through information.
- Create a modern regulatory framework and institutional structure to achieve those results.

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<sup>5</sup>For instance, in 1992, the Federal Financial Institutions Examination Council (FFIEC) recommended a narrowly-focused commission in its *Study on Regulatory Burden* (p. IV-2). The context of the recommendation indicates the recommendation included consumer- protection regulation: "An independent, nonpolitical group or commission charged with exploring possibilities for easing regulatory burden through broad political consensus could also be helpful. Such a commission could have limited life, be free of political partisanship, and be charged with making a comprehensive examination of all aspects of regulatory burden, especially that burden imposed through legislative mandates."

Appendix A to this Introduction provides further review of the NCCF's Report and lists its specific recommendations. Appendix B includes Commission members, its Report Foreword, staff, and its list of technical studies.

## 1.2 The Taskforce on Consumer Financial Law

Now the current Taskforce has received a similar charge to look at consumer-financial conditions and law after the second half of the current modern period, following fifty more years of changes. Although consumer credit necessarily continues as an important focus of the Taskforce's work, its scope is wider than the Commission's and includes more generally financial services on the consumer asset side, including payments products and services. Taskforce members were officially appointed in January 2020 and convened on January 29th for the first orientation to meet with the Director and Deputy Director to discuss the Taskforce charter. The Taskforce's charter specifies that it reports to the Director and will provide its report by January 2021.

The charter also says that the Director would appoint the Chair of the Taskforce and designate a Staff Director to "ensure that the Taskforce operates in accordance with the terms of the charter, in addition to other responsibilities delegated by the Director." The Director appointed Todd J. Zywicki, J.D., Professor of Law at George Mason University as Chair of the Taskforce and Matthew Cameron of the CFPB staff as initial staff director. J. Howard Beales, Ph.D., Thomas A. Durkin, Ph.D., William C. MacLeod, J.D., and Jean Noonan, J.D. were members of the Taskforce and who became employees of the CFPB. The membership and staff of the Taskforce are listed together in Appendix C to this chapter.

The charter also designates the Objective, Scope, and Duties of the Taskforce:

- The Taskforce will 1) examine the existing legal and regulatory environment facing consumers and financial services providers; and 2) report its recommendations for ways to improve and strengthen consumer financial laws and regulations, including recommendations for resolving conflicting requirements or inconsistencies, reducing unwarranted regulatory burdens in light of market of technological developments, improving consumer understanding of markets and products, and identifying gaps in knowledge that should be addressed through future Bureau research.
- The duties of the Taskforce are to provide an objective and independent evaluation, in the form of one consensus final report to the Director, of the Bureau's current regulatory framework. The findings should identify where there may be gaps or where regulation

should be simplified or modernized to help the Bureau more effectively carry out the mission of protecting consumers.

The Taskforce discussed this charter with the Director on January 29, 2020 and held an organizational meeting January 30-1. The Taskforce members responded enthusiastically to the project ahead and began delegating and dividing responsibility for leadership on the various components and chapters of a preliminary plan it outlined for the report to come. One of the first matters of business was to construct a plan for extensive outreach for information from the public, interested organizations, including consumer and trade groups, the Bureau's Advisory Councils, and other federal and state governmental agencies. At the next planning meeting in early March, the Taskforce designed a specific public Request for Information (RFI) and a series of meetings, listening sessions, and public hearings.

Unfortunately, the onset of the COVID-19 pandemic closed the Bureau's Washington headquarters the day after the outreach-planning meeting and dispersed the staff and large segments of the public to shelter-in-place status, causing havoc with the outreach plan for months. This meant that the Taskforce had to alter its outreach to later in the year and resulted in a more condensed version than anticipated.

At the January organizational meeting, the Taskforce had the opportunity to discuss the kinds of changes that had taken place in consumer financial services since the NCCF Report. Differences included widespread new technologies in the financial area, substantial increases in the amounts of credit in use, and a notable increase in federal regulatory efforts in a variety of areas. At the time of the NCCF, there was only one federal law directly aimed at consumer credit (Truth in Lending). Today there are eighteen major federal regulatory laws in the consumer area and a Federal Consumer Financial Protection Bureau established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010.

This discussion caused the Taskforce at its outset to look at the NCCF's findings again, with a new eye in a new technological era with new laws and regulations. At the same time, the Taskforce acknowledged the NCCF's importance and throughout this report the Taskforce broadly urges ongoing efforts of attention and renewal to the key areas the NCCF identified and were outlined above:

Continuing focus on inclusion by encouraging access to financial services through competitive markets;

- Consumer protection that eliminates archaic legal and illegal practices;
- Enhancing competition with new technologies;
- Improving consumer information and education; and

- Modernizing and rationalizing the regulatory structure that oversees consumer financial protection.

Providing for these needs and appropriate regulation in an economy as large, dynamic, and diverse as in the United States will always be a challenge requiring constant attention. Furthermore, advancing recommendations in these areas will always involve open-minded consideration of tradeoffs. For instance, empowering consumers to make their own choices can sometimes result in difficult outcomes for some of them. Likewise, banning products to protect some can reduce the welfare of others. Restricting new sorts of untried products or technologies may also restrict or minimize development of many cost and time-saving advantages, and so on.

As this Taskforce and its report focus on these central themes and lesser ones, and they continue to look at many specific questions raised by the NCCF in 1972, especially at areas that have remained important and sometimes controversial in the new era: reasons for credit use in the first place, usefulness and importance of access to credit, inclusion, competition, rate ceilings and their relation to credit availability and competition, small-dollar credit, unfair discrimination, disclosures, education, and interactions among supervisory agencies.

These are perennial issues and avoiding the wrong policy solutions or not paying proper attention to requirements that have become outmoded in these areas are matters requiring ongoing attention and consideration. This means that concerns of the NCCF remain important here, but this Taskforce Report does not overlook other newer issues. Many of the latter involve regulation of technological change, innovation, privacy, and education. These issues promise to become perennial as well and all of these matters probably will again be subjects for review by some future Commission or Taskforce more decades into the future. As noted above and discussed further in Chapter 2, the Taskforce report offers an overall look at consumer finance and consumer finance law at the end of the second half century of modern consumer credit, as the Report of the National Commission on Consumer Finance did after the first half century.

## 1.3 Scope of the Taskforce Report

While this report discusses a variety of aspects of consumer financial services, including shared concerns of technology, innovation, privacy, and developments in deposit and payments services, much of this report necessarily looks at consumer credit. For this reason, it is appropriate to define the consumer credit that is the subject of much the report and to say something at the outset about its importance. With this in mind, it is useful to summarize in more detail the scope and structure of the report that follows. Volume I examines the context of consumer finance and its regulation today, and Volume II looks more specifically at recommendations of the Taskforce.

Concerning context of the credit involved in much of the following discussion, we adopt the Federal Reserve Board’s widely used definition of consumer credit in its monthly statistical release “Consumer Credit” as “credit extended to individuals, excluding loans secured by real estate.” As outlined further in this monthly statistical release, this includes credit provided by depository institutions with banking charters, finance companies (including large auto lenders but also “payday” and other nonbank loan companies), credit unions, federal government (student loans), nonprofit and educational institutions, nonfinancial businesses (primarily retail stores and dealers), and holders of securitized assets. Consumer credit holdings of these institutions consist of both revolving credit and nonrevolving credit. Student loans, motor-vehicle loans, and credit cards fall within this definition, but not the huge mortgage-lending sector. Real-estate lending is certainly worth study and many academic and government agency studies have done so, but this area of modern finance is mostly not the subject at hand, except for its shared elements involving such matters as innovation, technology, privacy, and disclosures.

The consumer-credit sector of finance is immense on its own. From a base of about \$6.8 billion at the end of 1945 and its wartime restrictions for anti-inflationary purposes (Regulation W), domestic consumer credit outstanding grew to more than \$100 billion at the time of the NCCF and to more than \$4 trillion at the end of 2019. Big numbers are not necessarily indicative of big problems, but there can be no question that the amount of outstanding domestic consumer credit today is massive in dollar terms. The subsequent chapter discusses expansion and distribution of consumer credit. This is enough subject matter for a report to be constructed within one year, and so mortgage credit that involves many questions about underlying housing assets, real estate development, zoning issues, real estate investment trusts (REITs), taxation, and other specialized matters of housing-related finance remains largely outside the focus area. Even where consumer credit is concerned, the focus here is on financial services laws, economics, and regulation rather than on operating questions or management.

Chapter 2 begins the core of the Taskforce’s examination of consumer credit with a brief historical review of credit use by consumers and its regulation. This chapter then turns to examination of the subject of corresponding chapter in the NCCF’s Report, growth and distribution of consumer credit within the population. This section of Chapter 2 examines long-term growth of consumer credit use to shed some light on inclusion and on the question often asked whether consumer credit has grown too much for too long. It then reviews survey evidence on who uses consumer credit.

Chapter 3 explores the demand side of the consumer financial market, the reasons why consumers use credit.<sup>6</sup> This discussion examines the reasoning of neoclassical economics and also newer theories associated with the term “behavioral economics.” This chapter continues discussion of empirical findings from the previous chapter about how consumers use consumer credit. This leads to examination of rationales for regulation found later in Chapter 6. Government policies are often helpful, but should also be responsive to both important policy tradeoffs and risks of unintended consequences. Excessive regulation can also be costly or restrictive.

Chapter 4 examines the supply side of consumer financial markets, focusing on production costs for credit. Production costs are an important part of consumer lending and require a closer look. Costs that are too high for regulated prices also receive examination here and again in Chapter 5. This possibility advances the phenomenon of credit rationing.

Chapter 5 examines small-dollar credit and modern institutions that provide small-dollar credit. It explores provinces where credit rationing, controversy, and challenges regulating it are likely to occur. How to provide small amounts of credit at low prices has been problematic through recorded history, and the present is no exception.

This chapter also discusses what the Taskforce report characterizes as a normative issue. This is the concern whether any advisory commission or Taskforce can successfully make recommendations concerning access to small-dollar credit by those who use it. The difficulties and policy tradeoffs in this area suggest that no study or advisory group can easily answer all questions in this area in a way that is satisfactory to everyone. For instance, a study cannot suggest repeal of how generating such credit is costly relative to the loan size or how a substantial share of the observers of this lending are unhappy with the resulting higher interest rates. Any recommendations in this area go beyond the realms of law or economics and reach to philosophical questions of the role of government in a free society and how to reduce the problems of poverty after millennia of its existence. The Taskforce is not sanguine about this discussion, as the NCCF was not. The Taskforce again discusses the economics and issues of small-dollar lending but leaves the philosophical concerns surrounding the role of government in society or how to eradicate poverty to other contexts.

Chapter 6 focuses upon the conceptual underpinnings for undertaking economic regulation. After briefly examining underlying potential reasons for regulating and the intellectual history of economic regulation, this chapter looks at aspects of historical experience with consumer protection in the financial area. Regulatory areas and tools for consumer credit are discussed,

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<sup>6</sup>Later in this report, the Taskforce also variously discusses “consumer finance” more broadly to include also other consumer financial products, including consumer payments that do not involve extensions of credit.

and specific regulatory areas are enumerated. Necessarily, this chapter must circle back to the begged question, whether the whole of the current overlapping regulatory edifice is really needed, now a century into its construction. As with consumers' demand for credit where there can be overextensions, there also can be overextensions of regulation that produce unintended consequences. This is discussed here and later in Chapter 13.

Chapter 7 looks at disclosure as a consumer protection and how it might enhance or make simpler other sorts of protection. At a minimum, questions of consumer choice and the accompanying need for information can involve disclosures. Certainly, disclosure of relevant information also is important for making consumer-credit markets more competitive, which the NCCF discussed at considerable length in 1972. Need for information produced a whole new branch of economics in the 1960s (the Economics of Information), and it became an intellectual underpinning of the first federal foray into consumer protection regulation in the credit area: the Truth in Lending Act of 1968, intended as a disclosure law when passed.<sup>7</sup> This chapter also looks at what can go wrong with a disclosure regime.

Chapter 8 then focuses on competition more generally, the main underlying theme of the NCCF in 1972. This chapter examines in more detail the economic theories of competition, what competition can do for consumers as they use consumer credit and other financial services, and how competition interacts with regulation in markets today.

Chapter 9 examines innovation. Not only does innovation generate new products and new ways of doing things, but it also generates new divisions. Some observers embrace modernism and change as the hallmark of progress and advancement. Others emphasize the inability or slowness of some market participants to adapt to change, requiring control of the pace of change. Some fear that change will make things worse or less regulated. Pretty quickly, this leads to debate over the need for, or needed change in, regulatory regimes themselves. This chapter reviews new manifestations of this phenomenon for consumer financial services. The chapter looks in some detail at regulatory concerns over FinTechs, open banking, alternative data, regulatory sandboxes, and other current issues.

Chapter 10 focuses more precisely on inclusion. Inclusion as a regulatory matter extends at least to the efforts of the Russell Sage Foundation in the 1910s but also importantly to hearings on discrimination that the NCCF held in 1970-72. These hearings led directly to the Equal Credit Opportunity Act (1974 and 1976). More recently, regulation also impacts market incentives for using technology to advance inclusion. Such incentives have led to development of statistical

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<sup>7</sup>Federal controls on consumer credit during World War II, the late 1940s, and during the Korean War (Regulation W) were for economic stabilization and inflation-prevention purposes and not for consumer protection. For evaluation of the impact of Regulation W, see Board of GOVERNORS OF THE FEDERAL RESERVE SYSTEM, CONSUMER INSTALMENT CREDIT (six volumes, 1957).

credit scoring and automated credit-reporting agencies (CRAs, popularly known as “credit bureaus”). Both were designed to improve inclusion by reducing production costs. Questions now also involve potential impact of using new kinds of nontraditional data for improving inclusion and how regulation might affect this area.

Chapter 11 focuses on another new area of concern as technology has unfolded: implications for privacy and the potential for system failure. Privacy concerns arise not only from data breaches, but also from uses of personal data found by some observers to be inappropriate. Recently, the beginnings of large-scale regulation in this area advanced at the state level raise questions of a new set of regulatory inconsistencies across jurisdictions.

Chapter 12 examines various issues on consumer empowerment. This chapter looks first at financial literacy and education. These were areas of concern to the National Commission on Consumer Finance in 1972, and remain important matters today. This chapter also examines issues of household savings, especially retirement savings, and the special challenges and opportunities facing younger consumers today with respect to financial products.

Finally, Chapter 13 reviews issues of the regulatory structure today and whether there are jurisdictional challenges that can be mitigated. New laws and institutions have emerged and evolved over the past several decades in a piecemeal fashion. We focus on areas of regulatory redundancy and incompatibility, as well as lacunae or oversights in the consumer financial regulatory system, both on the federal level and with respect to state authority. This chapter discusses such issues and how appropriate Memoranda of Understanding (MOUs) carefully outlining joint operations and territories in some cases might well benefit everyone.

Overall, these chapters renew and revitalize the work begun by the NCCF in examining the progress of domestic consumer financial matters and their institutions. The NCCF examined the first 50 years of modern consumer credit, from the reforms of the Russel Sage Foundation to the dawn of its federal regulation. The next 50 years have witnessed growth in access to financial services, further growth in public acceptance of consumer credit and other financial services, advances in technology, and ongoing regulation. It is worth stepping back and looking at the underpinnings and current development of these important and widespread phenomena again.



## CHAPTER 1, APPENDIX A:

# Review of the Report and Recommendations of the National Commission on Consumer Finance in 1972

The NCCF's Congressional charge is in paragraph 404 of Title IV of the Consumer Credit Protection Act (Public Law 90-321, May 29, 1968):

(a) The Commission shall study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions, generally. The Commission, in its report and recommendations to the Congress, shall include treatment of the following topics:

- (1) The adequacy of existing arrangements to provide consumer credit at reasonable rates.
- (2) The adequacy of existing supervisory and regulatory mechanisms to protect the public from unfair practices and inspire the informed use of consumer credit.
- (3) The desirability of federal chartering of finance companies, or other federal regulatory measures.

(b) The Commission may make interim reports and shall make a final report of its findings, recommendations, and conclusions to the President and to Congress by January 1, 1971. [Note: Due to delays in appointing members of the Commission and for other reasons, Congress subsequently changed the date to December 31, 1972.]

Title IV specified that Commission members were to be three designees from the House of Representatives, three members of the Senate, and three public members appointed by the President, one of whom was to be chairman. This made the Commission bipartisan but not nonpartisan. The longest section of Title IV was paragraph 405, concerning subpoena powers and other aspects of the Commission's operations that are not relevant today.

The Commission's Report consisted of 12 chapters and measured 294 pages. There were forward and appendix sections containing summary of recommendations, separate statements of Commission members (in part reflective of differing political views), summary of hearings, a list of studies, and extensive footnotes. After publication of its Report (and after some delays at the Government Printing Office), the NCCF also published six volumes of its technical studies. The recommendations themselves were embedded within the relevant chapters of the Report where the reasoning supporting each of them individually resided, as well as listed together in a forward section. The chapters were:

1. An Overview of the Study and Some Conclusions
2. Development and Structure of Consumer Credit
3. Creditors' Remedies and Contract Provisions
4. Supervisory Mechanisms
5. Credit Insurance
6. Rate Ceilings
7. Rates and Availability of Credit
8. Special Problems of Availability
9. Federal Chartering
10. Disclosure
11. Education
12. The Future of Consumer Credit

Overall, a careful reading of the NCCF Report reveals six main themes (combined and summarized into five earlier) that run through its entirety and its recommendations (a complete listing of the NCCF's specific recommendations is at the end of this appendix, and its membership, staff, and studies are in Appendix B to this chapter):

1. Emphasizing the importance of institutional competition as a main bulwark of consumer protection, focusing on the need to remove and/or prevent any existing and future barriers to entry to support this goal.
2. Rethinking the role of legislated or regulatory interest-rate ceilings. In the view of the Commission, they were a barrier to entry that not only interfered with competition, but also

made many situations of credit availability worse, sometimes even leading to credit unavailability.

3. Including everyone in fair consumer credit markets.
4. Eliminating excesses in consumer credit markets associated with archaic collection methods and practices.
5. Continuing improvement in the flows of information to consumers about their financial transactions.
6. Ensuring adequate supervision and enforcement where currently insufficient.

These themes are quite visible early in the Report, even forming the bulk of the transmittal letter from the NCCF Chairman Ira M. Millstein to the President and Congress (p. iii):

As to the Report itself, I believe the Commission was unanimous in concluding that a truly competitive consumer credit market, with adequate disclosure of relevant facts to an informed consuming public, together with legislation and regulation to eliminate excesses, will foster economic growth and serve to optimize benefits to the consumer.

As to excesses in the marketplace, our Report recommends significant additions to the protection of consumers in the fields of creditors' remedies and collection practices. We have urged restrictions on remedies such as garnishment, repossession, and wage assignment. We have recommended abolition of the holder in due course doctrine, confessions of judgment, and harassing tactics in debt collections.

As to adequate disclosure of relevant facts, our Report urges enhanced supervision and enforcement of the Federal Truth in Lending Act. We have also specified actions to make the disclosure features of Truth in Lending more effective and have suggested expanding the coverage of that Act to include disclosure of charges for credit life and accident and health insurance as an annual percentage rate.

We also favored making federally chartered financial institutions subject to state as well as federal examination for compliance with state laws governing the terms and conditions of consumer credit extensions. In addition, we recommended expanded administrative authority over all classes of creditors.

As to our conclusion that free and fair competition is the ultimate and most effective protector of consumers, we have recommended the elimination of restrictive barriers to entry in consumer credit markets by permitting all creditors open access to all areas of consumer credit. We have urged the entry of savings and loan associations and mutual savings banks into the consumer credit market. We have recommended prohibitions on acquisitions that would eliminate

potential competition or that would substantially increase concentration in state or local credit markets. We have also urged that rate ceilings, which constrain the development of workably competitive markets be reviewed by those states seeking to increase credit availability at reasonable rates.

Some of these areas, notably including some of the most controversial at the time, seem settled or even a bit archaic today, almost 50 years later. For instance, allowable creditors' remedies, a controversial area then and discussed in one of the longest chapters in the NCCF's Report (Chapter 3), have changed considerably since the NCCF's time. In the intervening years, federal and state actions have eliminated many private actions such as confessions of judgement that were permissible in the past. Many of the specific creditors' remedies discussed by the NCCF are more of historical interest today than current concerns.

Further, one of the central themes through the Commission's Report in 1972 seems agreed upon today: the need for promoting competition in consumer credit markets by preventing barriers to entry. There is ongoing need for government to encourage competition among service providers, but many of the Commission's recommendations for removal of legislative and regulatory barriers to entry like licensing requirements designed to restrict entry have been implemented in the intervening years.

The NCCF also argued for maintaining large numbers of individually competing firms by antitrust action to prevent mergers that would increase market concentration in a smaller number of firms. This specific need today is a matter of debate in antitrust law concerning financial services, but many other intervening institutional changes have meanwhile contributed importantly to increased competition. They include many of the technological advances in data processing, storage, and analysis that have taken place since the NCCF's time.

Technological change has permitted wider geographic spheres for competing institutions. For instance, today worldwide credit card operations of distant banking entities and instant acceptance of financial products like credit cards globally have pushed credit competition far beyond localized markets prevalent in the past. Today, many financial institutions compete at least nationally. Technology has also permitted availability of comprehensive credit-bureau histories and credit-bureau risk scores to any potential lender at low cost, eliminating barriers to entry in the information area.

Another somewhat archaic area involves credit insurance, where the main question for the NCCF was competitiveness of markets for the product (Chapter 5 of the NCCF Report). This product is still around today, but it can be considered to a degree a niche product now, and it is subject to price ceilings and regulated by insurance or financial-institutions regulatory departments in all the states.

An area that has not settled down is supervisory mechanisms (Chapter 4 of the NCCF Report), despite many changes. States generally had departments of banking or financial institutions and sometimes consumer affairs in the NCCF era, but structures, responsibilities, authority, and resources of the state agencies varied widely. There were inconsistencies both across states and, often, the relevant supervisory bodies within a state. Consumer credit regulation was mostly not a domain of federal activity then, with Truth in Lending and bankruptcy law the exceptions, the latter specifically enumerated as a federal responsibility in the 1789 Constitution. Now there are professional agencies or departments responsible for consumer affairs within the financial regulatory structures of all the states and in the federal government.

At the time of the NCCF, the focus of the federal financial regulatory agencies was almost solely on institutional safety and soundness of those under their charge. Today, these agencies also have departments of consumer affairs and relevant examination and enforcement staff in this area. Further, the Federal Trade Commission retains its long-standing Bureau of Consumer Protection, and in 2010, Congress instituted the Consumer Financial Protection Bureau. This agency has responsibility today over 18 major pieces of federal legislation, only one of which was in effect at the time when the NCCF prepared its Report (Truth in Lending). And so, further federal supervision that was still a question at the time of the NCCF is now well evident.

All these agencies and departments operating in essentially the same area today, however, raise substantial questions, beginning with federalism and coordination of responsibilities across levels of government. Issues involve interaction between federal legislation and agencies with similar responsibilities at the state level but also coordination among federal agencies themselves. Today, there are questions of jurisdiction, overlap, and efficiency of the entire system built over the decades since the NCCF Report.

Concerns like federal chartering of finance companies and other entities (Chapter 9 of the NCCF Report) have gone and returned over the decades. As indicated, until 1968 the federal government had relatively little presence in consumer financial regulation, but this has changed without instituting new federal chartering. The question of federal chartering has come back again recently, with discussion whether there should be federal chartering and regulation of companies that might want to provide credit and other consumer financial services using new technologies, known typically today as “FinTechs.”

Among the most controversial sections of the NCCF Report in 1972, and the parts containing a substantial part of the NCCF’s unfinished business today, are the chapters right in the middle of the Report: “Rate Ceilings” (Chapter 6), “Rates and Availability of Credit” (Chapter 7), and “Special Problems of Availability” (Chapter 8). All these chapters involved interest-rate ceilings that were prevalent at the time and their impact. Chapter 8 also reviewed some other interrelated questions concerning unfair discrimination and credit availability.

Rate ceilings on credit use have been controversial for centuries, and the NCCF paid them central attention. The regimes of state rate ceilings in place at the time changed soon afterward, clearly not due solely to the NCCF. Rapid changes in rate-ceiling laws at the time undoubtedly owed some intellectual debt to the NCCF Report, but the driving forces were the extremely high interest-rate periods of the late 1970s and early 1980s that caused many economic disruptions at the time. They included upheavals in housing markets where ceilings interfered with both home sales and housing construction.

By the early 1980s, federal legislation that was part of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), had removed commercial and housing credit from state rate regulation. At the same time or shortly afterward, many states also altered their rate regulations on consumer credit, often raising or eliminating ceilings on various kinds of credit within their jurisdictions. Court decisions around the same time enabled national banks located in states with less restrictive rate ceilings to charge their home-state rates on credit extended to borrowers located in other, more restrictive states.

After the extreme interest rates worldwide subsided a bit by the middle and later 1980s, alterations of legislated ceilings continued. Since then, many states have further changed their rate regulations, raising ceilings in some cases, reducing ceilings elsewhere, or adapting them to new institutions. More recent changes have mostly involved small-dollar lenders such as so-called “payday lenders,” where some states have specifically allowed them, and others specifically prohibited them. At the federal level, Congress adopted the Military Lending Act in 2006 establishing federal rate ceilings on some kinds of consumer credit for military families. Since then, there has been discussion of extending the federal rate ceilings in the Military Lending Act to civilian consumer credit.

Chapter 6 of the NCCF Report provided general background on rates and rate ceilings, and Chapter 7 looked more closely at new empirical evidence about them, much of it based upon the NCCF’s data-gathering efforts. Besides continuing this discussion, Chapter 8 looked at other special questions involving credit availability, notably including credit discrimination considered unfair.

Credit discrimination was not part of federal regulatory activity at the time the NCCF delivered its Report in December 1972. Congress passed the Equal Credit Opportunity Act later in 1974 and extensively revised it afterward in 1976. Nonetheless, the Commission held a set of public hearings on this issue and considered this area at considerable length in Chapter 8 of its Report. Eliminating unfair credit discrimination itself has not generally been controversial since passage of the Equal Credit Opportunity Act in 1974 and its extensive amendment in 1976, but the precise regulatory definition of illegal discrimination has been subject of concerns and remains so.

One other key area studied by the NCCF has also remained controversial: disclosures (Chapter 10 of the NCCF Report). Most observers favor relevant disclosures on financial transactions, but the questions always have surrounded the proper extent of relevant disclosures for what purposes and when.

At the time of the NCCF, Truth in Lending was still the only significant area of federal government presence in consumer credit regulation (other than bankruptcy that is a federal responsibility according to the Constitution), and not surprisingly, the NCCF discussed disclosures at some length. The NCCF also sponsored original research projects in this area, which it reviewed in its Report.

Since that time, additional disclosures have been an element of every further federal legislative effort in the consumer credit area including fair credit reporting, equal credit opportunity, bankruptcy reform, privacy, and electronic funds transfers. Further, the Truth in Lending Act has been amended many times over its five decades, and it has seemed like its implementing rules (Regulation Z and its Official Commentary) have been in almost constant flux. Continued reliance on disclosures as consumer protections means that concern whether disclosures are “effective” or not has never disappeared.

In many ways, consumer education is closely related to disclosures, and the NCCF addressed it in Chapter 11 before its conclusory observations about the future of consumer credit in Chapter 12. Since new consumers develop every year with population growth and the passage of time, this issue never gets old, and the Taskforce discusses it again in its own Chapter 12 before its concluding look at regulatory jurisdiction in its Chapter 13.

The following is a full listing of the recommendations of the NCCF in its 1972 Report:

A Full Listing of the Recommendations of the National Commission on Consumer Finance enumerated in its Report to the President and Congress in December 1972

## Contract Provisions and Creditors’ Remedies (Chapter 3)

### Contract Provisions

#### Acceleration Clauses – Default - Cure of Default

Acceleration of the maturity of all or any part of the amount owing in a consumer credit transaction should not be permitted unless a default as specified in the contract or agreement has occurred.

A creditor should not be able to accelerate the maturity of a consumer credit obligation, commence any action, or demand or take possession of any collateral, unless the debtor is in default, and then only after he has given 14 days prior written notice to the debtor of the alleged default of the amount of the delinquency (including late charges), of any performance in addition to payment required to cure the default and of the debtor's right to cure the default.

Under such circumstances, for 14 days after notice has been mailed, a debtor should have the right to cure a default arising under a consumer credit obligation by:

1. Tendering the amount of all unpaid instalments due at the time of tender, without acceleration, plus any unpaid delinquency charges; and by
2. Tendering any performance necessary to cure a default other than nonpayment of accounts due.

However, a debtor should be able to cure no more than three defaults during the term of the contract. After curing default, the debtor should be restored to all his rights under the consumer credit obligation as though no default had occurred.

## Attorney's Fees

Consumer credit contracts or agreements should be able to provide for payment of reasonable attorney's fees by the debtor in the event of default if such fees result from referral to an attorney who is not a salaried employee of the creditor; in no event should such fees exceed 15 percent of the outstanding balance. However, this agreement should further stipulate that in the event suit is initiated by the creditor and a court finds in favor of the consumer, the creditor should be liable for the payment of the debtor's attorney's fees as determined by the court, measured by the amount of time reasonably expended by the consumer's attorney and not by the amount of the recovery.

## Confessions of Judgment - Cognovit Notes

No consumer credit transaction contract should be permitted to contain a provision whereby the debtor authorizes any person, by warrant of attorney or otherwise, to confess judgment on a claim arising out of the consumer credit transaction without adequate prior notice to the debtor and without an opportunity for the debtor to enter a defense.

## Cross-Collateral

In a consumer credit sale, the creditor should not be allowed to take a security interest in goods or property of the debtor other than the goods or property which are the subject of the sale. In the case of "add-on" sales, where the agreement provides for the amount financed and finance charges resulting from additional sales to be added to an existing outstanding balance, the



creditor should be able to retain his security interest in goods previously sold to the debtor until he has received payments equal to the sales price of the goods (including finance charges). For items purchased on different dates, the first purchased should be deemed the first paid for; and for items purchased on the same date, the lowest priced items should be deemed the first paid for.

## Household Goods

A creditor should not be allowed to take other than a purchase money security interest in household goods.

## Security Interest – Repossession - Deficiency Judgments

A seller-creditor should have the right to repossess goods in which a security interest exists upon default of contract obligations by the purchaser-debtor. At the time the creditor sends notice of the cure period (14 days), and prior to actual repossession (whether by replevin with the aid of state officers or by self-help), the creditor may simultaneously send notice of the underlying claim against the debtor and the debtor should be afforded an opportunity to be heard in court on the merits of such claim. The time period for an opportunity to be heard may run concurrently with the cure period.

Where default occurs on a secured credit sale in which the original sales price was \$1,765 or less, or on a loan in which the original amount financed was \$1,765 or less and the creditor took a security interest in goods purchased with the proceeds of such loan or in other collateral to secure the loan, the creditor should be required to elect remedies: either to repossess collateral in full satisfaction of the debt without the right to seek a deficiency judgment, or to sue for a personal judgment on the obligation without recourse to the collateral, but not both.

## Wage Assignments

In consumer credit transactions involving an amount financed exceeding \$300, a creditor should not be permitted to take from the debtor any assignment, order for payment, or deduction of any salary, wages, commissions, or other compensation for services or any part thereof earned or to be earned. In consumer credit transactions involving an amount financed of \$300 or less, where the creditor does not take a security interest in any property of the debtor, the creditor should be permitted to take a wage assignment but in an amount not to exceed the lesser of 25 percent of the debtor's disposable earnings for any workweek or the amount by which his disposable earnings for the workweek exceeds 40 times the federal minimum hourly wage prescribed by section 6(a) (I) of the Fair Labor Standards Act of 1938 in effect at the time.

## Creditors' Remedies

### Body Attachment

No creditor should be permitted to cause or permit a warrant to issue against the person of the debtor with respect to a claim arising from a consumer credit transaction. In addition, no court should be able to hold a debtor in contempt for failure to pay a debt arising from a consumer credit transaction until the debtor has had an actual hearing to determine his ability to pay the debt.

### Garnishment

Prejudgment garnishment, even of nonresident debtors, should be abolished. After entry of judgment against the debtor on a claim arising out of a consumer credit transaction, the maximum disposable earnings of a debtor subject to garnishment should not exceed the lesser of:

1. 25 percent of his disposable earnings for the workweek, or
2. The amount by which his disposable earnings for the workweek exceeds 40 times the federal minimum hourly wage prescribed by section 6(a) (!) of the Fair Labor Standards Act of 1938, in effect at the time the earnings are payable. (In the event of earnings payable for a period greater than a week, an appropriate multiple of the federal minimum hourly wage would be applicable.)

A debtor should be afforded an opportunity to be heard and to introduce evidence that the amount of salary authorized to be garnished would cause undue hardship to him and/or his family. In the event undue hardship is proved to the satisfaction of the court, the amount of the garnishment should be reduced or the garnishment removed.

No employer should be permitted to discharge or suspend an employee solely because of any number of garnishments or attempted garnishments by the employee's creditors.

### Holder in Due Course Doctrine-Waiver of Defense Clauses-Connected Loans

Notes executed in connection with consumer credit transactions should not be "negotiable instruments;" that is, any holder of such a note should be subject to all the claims and defenses of the maker (the consumer-debtor). However, the holder's liability should not exceed the original amount financed. Each such note should be required to have the legend "Consumer Note - Not Negotiable" clearly and conspicuously printed on its face.

Holders of contracts and other evidences of debts which are executed in connection with consumer credit transactions other than notes should similarly be subject to all claims and defenses of the consumer-debtor arising out of the transaction, notwithstanding any agreement to the contrary. However, the holder's liability should not exceed the original amount financed.

A creditor in a consumer loan transaction should be subject to all of the claims and defenses of the borrower arising from the purchase of goods or services purchased with the proceeds of the loan, if the borrower was referred or otherwise directed to the lender by the vendor of those goods or services and the lender extended the credit pursuant to a continuing business relationship with the vendor. In such cases, the lender's liability should not exceed the lesser of the amount financed or the sales price of the goods or services purchased with the proceeds of the loan.

## Levy on Personal Property

Prior to entry of judgment against a debtor arising out of a consumer credit transaction, while a court may create a lien on the personal property of the debtor, that lien should not operate to take or divest the debtor of possession of the property until final judgment is entered. However, if the court should find that the creditor will probably recover in the action, and that the debtor is acting or is about to act in a manner which will impair the creditor's right to satisfy the judgment out of goods upon which a lien has been established, the court should have authority to issue an order restraining the debtor from so acting. The following property of a consumer debtor should be exempt from levy, execution, sale, and other similar process to satisfy judgment arising from a consumer credit transaction (except to satisfy a purchase money security interest created in connection with the acquisition of such property).

1. A homestead to the fair market value of \$5,000 including a house, mobile home, or like dwelling, and the land it occupies if regularly occupied by the debtor and/or his family as a dwelling place or residence and intended as such.
2. Clothing and other wearing apparel of the debtor, spouse, and dependents to the extent of \$350 each.
3. Furniture, furnishings, and fixtures ordinarily and generally used for family purposes in the residence of the debtor to the extent of the fair market value of \$2,500.
4. Books, pictures, toys for children and other such kinds of personal property to the extent of \$500.
5. All medical health equipment being used for health purposes by the debtor, spouse, and dependents.

6. Tools of trade, including any income-producing property used in the principal occupation of the debtor, not to exceed the fair market value of \$1,000.
7. Any policy of life or endowment insurance which is payable to the spouse or children of the insured, or to a trustee for the benefit of the spouse or children of the insured, except the cash value or any accrued dividends thereof.
8. Burial plots belonging to the debtor and/or spouse or purchased for the benefit of minor children to the total value of \$1,000.
9. Other property which the court may deem necessary for the maintenance of a moderate standard of living for the debtor, spouse, and dependents.

## Contacting Third Parties

No creditor or agent or attorney of a creditor before judgment should be permitted to communicate the existence of an alleged debt to a person other than the alleged debtor, the attorney of the debtor, or the spouse of the debtor without the debtor's written consent.

## Miscellaneous Recommendations

### **BALLOON PAYMENT**

With respect to a consumer credit transaction, other than one primarily for an agricultural purpose or one pursuant to open end credit, if any scheduled payment is more than twice as large as the average of earlier scheduled payments, the consumer should have the right to refinance the amount of that payment at the time it is due without penalty. The terms of the refinancing should be no less favorable to the consumer than the terms of the original transaction. These provisions do not apply to a payment schedule which, by agreement, is adjusted to the seasonal or irregular income of the consumer.

### **COSIGNER AGREEMENTS**

No person other than the spouse of the principal obligor on a consumer credit obligation should be liable as surety, cosigner, comaker, endorser, guarantor, or otherwise assume personal liability for its payment unless that person, in addition to signing the note, contract, or other evidence of debt also signs and receives a copy of a separate cosigner agreement which explains the obligations of a cosigner.

### **REBATES FOR PREPAYMENT**

A consumer should always be allowed to prepay in full the unpaid balance of any consumer credit obligation any time without penalty. In such instances, the consumer should receive a rebate of the unearned portion of the finance charge computed in accordance with the "balance of the digits" (otherwise known as "sum of the digits" or "rule of 78's" method) or the actuarial

method. For purpose of determining the instalment date nearest the date of prepayment, any prepayment of an obligation payable in monthly instalments made on or before the 15th day following an instalment due date should be deemed to have been made as of the instalment due date, and if prepayment occurs on or after the 16th it should be deemed to have been made on the succeeding instalment due date. If the total of all rebates due to the consumer is less than \$1 no rebate should be required.

In the event of prepayment, the creditor should not be precluded from collecting or retaining delinquency charges on payments due prior to prepayment.

In the case of credit for defective goods, the consumer should be entitled to the same rebate as if payment in full had been made on the date the defect was reported to the creditor or merchant.

If the maturity of a consumer credit obligation is accelerated as a result of default, and judgment is obtained or a sale of secured property occurs, the consumer should be entitled to the same rebate that would have been payable if payment in full had been made on the date judgment was entered or the sale occurred.

Upon prepayment in full of a consumer credit obligation by the proceeds of credit insurance, the consumer or his estate should be entitled to receive the same rebate that would have been payable if the consumer had prepaid the obligation computed as of the date satisfactory proof of loss is furnished to the company.

## **Unfair Collection Practices**

### **HARASSMENT**

No creditor, agent or attorney of the creditor, or independent collector should be permitted to harass any person in connection with the collection or attempted collection of any debt alleged to be owing by that person or any other person.

### **SEWER SERVICE**

If a debtor has not received proper notice of the claim against him and does not appear to defend against the claim, any judgment entered shall be voided and the claim reopened upon the debtor's motion.

### **INCONVENIENT VENUE**

No creditor or holder of a consumer credit note or other evidence of debt should be permitted to commence any legal action in a location other than (1) where the contract or note was signed, (2) where the debtor resides at the commencement of the action, (3) where the debtor resided at the time the note or contract was made, or (4) if there are fixtures, where the goods are affixed to real property.

## **CONSUMER CREDIT AND CONSUMER INSOLVENCY**

Chapter XIII of the Bankruptcy Act should be expanded as endorsed by the House of Delegates of the American Bar Association in July 1971 to permit Chapter XIII courts, under certain circumstances, to alter or modify the rights of secured creditors when they find that the plan adequately protects the value of the collateral of the secured creditor.

In petitions for relief in bankruptcy, the bankruptcy court should disallow claims of creditors stemming from "unconscionable" transactions.

Bankruptcy courts should provide additional staff to serve as counselors to debtors regarding their relations with creditors, and their personal, credit, and domestic problems.

## **DOOR-TO-DOOR SALES**

In any contract for the sale of goods entered into outside the creditor's place of business and payable in more than four installments, the debtor should be able to cancel the transaction at any time prior to midnight of the third business day following the sale.

## **ASSESSMENT OF DAMAGES**

If a creditor in a consumer credit transaction obtains a judgment by default, before a specific sum is assessed the court should hold a hearing to establish the amount of the debt the creditor-plaintiff is lawfully entitled to recover.

# **Supervisory Mechanisms (Chapter 4)**

The Commission recommends that:

Legislatures and administrators in states with less than 2-1/2 man-days available per year per small loan office reassess their staffing capabilities with the goal of improving their ability to fulfill the examination responsibility prescribed by law.

All federal regulatory agencies adopt and enforce uniform standards of Truth in Lending examination.

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 Truth in Lending; an independent Consumer Credit Agency be created in the event that the proposed Consumer Protection Agency is not established by Congress; the independent agency would have the same functions and authorities recommended for the Bureau of Consumer Credit.

Agencies supervising federally chartered institutions undertake systematic enforcement of federal credit protection laws like Truth in Lending.

Federal law be expressly changed to authorize state officials to examine federally chartered institutions for the limited purpose of enforcing state consumer laws, but such authorization should in no way empower state officials to examine federally chartered institutions for soundness, fraudulent practices, or the like; the limited state examinations should be required by law to be performed in a manner that would not disrupt or harass the federally chartered institutions.

State consumer credit laws be amended to bring second mortgage lenders and any other consumer lenders under the same degree of administrative control imposed on licensed lenders.

Congress consider whether to empower state officials to enforce Truth in Lending and garnishment restrictions of the Consumer Credit Protection Act and any similar laws that may be enacted.

State laws covering retailers and their assignees be amended, where necessary, to give authority to a state administrative agency to enforce consumer credit laws against all sellers who extend consumer credit; but administrative regulation need not and should not entail either licensing or limitations on market access.

States which do not subject sales finance companies to enforcement of consumer credit laws amend their laws to bring such companies under enforcement; such authority need not and should not entail licensing or limitations on market access.

State laws be amended to give a state administrative agency authority to enforce consumer credit laws against all credit grantors - deposit holding institutions, nondeposit holding lenders, and retailers and their assignees. This authority should include the right to enter places of business, to examine books and records, to subpoena witnesses and records, to issue cease and desist orders to halt violations, and to enjoin unconscionable conduct in making or enforcing unconscionable contracts. The agency should be able to enforce the right of consumers, as individuals or groups, to refunds or credits owing to them under appropriate statutes.

Legal services programs - legal aid, neighborhood legal services, rural legal assistance, public defender - continue to receive federal, state, and local government support.

Consumer protection laws be amended, where necessary, to assure payment of legal fees incurred by aggrieved private consumers and provide them with remedies they can enforce against creditors who violate these laws.

The proposed BCC be authorized to establish a National Institute of Consumer Credit to function as the BCC's research arm.

The BCC, acting through the National Institute of Consumer Credit, be empowered to cooperate with and offer technical assistance to states in matters relating to consumer credit protection-examinations, enforcement, and supervision of consumer credit protection laws.

The BCC be authorized:

to require state and federal agencies engaged in supervising institutions which grant consumer credit to submit such written reports as the Bureau may prescribe;

to administer oaths;

1. to subpoena the attendance and testimony of witnesses and the production of all documentary evidence relating to the execution of its duties;
2. to intervene in corporate mergers and acquisitions where the effect would be to lessen competition in consumer credit markets, to include but not be limited to applications for new charters, offices, and branches;
3. to invoke the aid of any district court of the United States in requiring compliance in the case of disobedience to a subpoena or order issued;
4. to order testimony to be taken by deposition before any person designated by the Bureau with the power to administer oaths, and in such instances to compel testimony and the production of evidence in the same manner as authorized under subparagraphs (3) and (5) above.

## Credit Insurance (Chapter 5)

The Commission recommends that:

The finance charge earned by credit grantors should be sufficient to support the provision of the credit service. The finance charge should not subsidize the credit insurance service. Nor should the charge for credit insurance subsidize the credit operation.

The proposed Bureau of Consumer Credit in the Consumer Protection Agency make a study to determine acceptable forms of credit insurance and reasonable levels of charge and prepare recommendations.

The states should immediately review charges for credit insurance in their jurisdictions and lower rates where they are excessive.



Creditors offering credit life and accident and health insurance be required to disclose the charges for the insurance both in dollars and cents and as an annual percentage rate in the same manner as finance charges and annual percentage rates of finance charges are required to be disclosed under the Truth in Lending Act and Regulation Z.

## Rates and Availability of Credit (Chapter 7)

Although the Commission makes no generally applicable recommendation concerning branch banking because conditions can vary among the states, it does recommend that where statewide branching is allowed, specific steps be taken to assure easy new entry and low concentration. Such steps would:

1. Give preferential treatment wherever possible to charter applications of newly forming banks as opposed to branch applications of dominant established banks.
2. Favor branching, especially de novo branching, whether directly or through the holding company device when such branching promotes competition. Banking regulators should exercise a high degree of caution in permitting statewide branching whether directly or through the holding company device when such branching decreases competition or increases economic concentration.
3. Encourage established banks and regulatory agencies to see that correspondent bank services be made available (for a reasonable fee) to assist newly entering independent banks, including the provision of loan participation agreements when needed.
4. Disallow regional expansion by means of merger and holding company acquisitions when such acquisitions impair competition, recognizing that statewide measures of competition are relevant.

The Commission recommends, as did the President's Commission on Financial Structure and Regulation, that under prescribed conditions savings and loan associations and mutual savings banks be allowed to make secured and unsecured consumer loans up to amounts not to aggregate in excess of 10 percent of total assets.

The Commission recommends that the only criterion for entry (license) in the finance company segment of the consumer credit market be good character, and that the right to market entry not be based on any minimum capital requirements or convenience and advantage regulations. The Commission recommends that direct bank entry in the relatively high risk segment of the personal loan market be made feasible by:

1. Permitting banks to make small loans under the rate structure permitted for finance companies;

2. Encouraging banks to establish de novo small loan offices as subsidiary or affiliated separate corporate entities. Regardless of corporate structure these small loan offices, whether corporate or within other bank offices, should be subject to the same examination and supervisory procedures that are applied to other licensed finance companies;
3. Exempting consumer loans from the current requirement that bank loan production offices obtain approval for each loan from the bank's main office; and
4. Prohibiting the acquisition of finance companies by banks when banks are permitted to establish de novo small loan offices. The Commission recommends that existing regulatory agencies disallow mergers or stock acquisitions among any financial institutions whenever the result is a substantial increase in concentration on state or local markets.

The Commission recommends that inter-institutional acquisitions be generally discouraged even though there is no effect on intra-institutional concentration.

The Commission recommends that state regulatory agencies and legislatures review the market organization of their respective financial industries after a 10-year trial period of earnest implementation of the recommendations on market entry and concentration. If, despite these procompetitive efforts, such a review discloses an inadequacy of competition-as indicated, say, by a continuing market dominance by a few commercial banks and finance companies or the absence of more frequent entry - then a restructuring of the industry by dissolution and divestiture would probably be appropriate and beneficial.

The Commission recommends that antitrust policy, both federal and state, be alert to restrictive arrangements in the credit industry. Any hint of agreement among lenders as to rates, discounts, territorial allocations and the like must be vigorously pursued and eliminated.

The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

## Discrimination (Chapter 8)

The Commission recommends that:

States undertake an immediate and thorough review of the degree to which their laws inhibit the granting of credit to creditworthy women and amend them, where necessary, to assure that credit is not restricted because of a person's sex.

Congress establish a pilot consumer loan fund and an experimental loan agency to determine whether families whose incomes are at or below the Federal Guideline for Poverty Income Levels issued annually by OEO have the ability to repay small amounts of money which they may need to borrow.

\$1.5 million be appropriated for an experimental low income loan program to be allocated among operating expenses, loss write-offs, and loan extensions according to guidelines developed by an advisory committee to the Bureau of Consumer Credit.

There be continued experimentation by private industry in cooperation with federal, state, and local governments to provide credit to the poor.

Legislation permitting "small small" loans should be encouraged as a suitable means of providing loans to the poor from regulated, licensed lenders.

## Federal Chartering (Chapter 9)

The Commission recommends that federal chartering of finance companies be held in abeyance for 4 years while two complimentary courses of action are pursued: (1) efforts should be undertaken to persuade the states to remove from existing laws and regulations anticompetitive (and by extension, anti-consumer) restrictions on entry and innovation and, (2) Congress should sustain the research initiated by the Commission.

If the substantive portions of the Commission's recommendations regarding workably competitive markets are not enacted within 4 years and states have not eliminated barriers to entry, the Commission recommends that Congress permit federal chartering of finance companies with powers to supersede state laws in three basic areas which sometimes severely limit competition in availability of credit: limitations on entry, unrealistic rate ceilings, and restraints on amounts and forms of financial services offered consumers.

## Disclosure (Chapter 10)

The Commission recommends that:

The Board of Governors of the Federal Reserve System regularly publish a statistical series showing an average (and possibly a distribution) of annual percentage rates for at least three major types of closed end consumer instalment credit: new automobiles, mobile homes, and personal loans.

The Truth in Lending Act should be further amended to require creditors who do not separately identify the finance charge on credit transactions involving more than four instalments to state

clearly and conspicuously in any advertisement offering credit: "THE COST OF CREDIT IS INCLUDED IN THE PRICE QUOTED FOR THE GOODS AND SERVICES."

The Truth in Lending Act be amended to make clear the presumption that all discounts or points, even when paid by the seller, are passed on to the buyer and hence must be included in the finance charge.

Section 106(e) of the Truth in Lending Act be amended to delete as excludable from the finance charge the following items numbered in accordance with that paragraph:

(5) Appraisal fees

(6) Credit reports

A full statement of all closing costs to be incurred be presented to a consumer prior to his making any downpayment. In any case, a full statement of closing costs should be provided at the time the lender offers a commitment on a consumer credit real property transaction or not later than a reasonable time prior to final closing.

Section 104(4) of the Truth in Lending Act which exempts public utility transactions from disclosure requirements be repealed. Creditors be required to disclose the charge for credit insurance both in dollars and as an annual percentage rate in the same manner as the finance charge is required to be disclosed. Additionally, where credit insurance is advertised, that the premium be required to be expressed as an annual percentage rate.

Exempted transactions (Section 104) of the Truth in Lending Act should include credit transactions primarily for agricultural purposes in which the total amount to be financed exceeds \$25,000, irrespective of any security interest in real property.

Creditors offering open end credit be permitted to advertise only the periodic rate and the annual percentage rate;

Where terms other than rates are advertised, only the following terms be stated in the advertisement:

- Closed end credit
- The cash price or the amount of the loan as applicable.
- The number, amount, and due dates or period of payments scheduled to repay the indebtedness if the credit is extended.

- The annual percentage rate, or the dollar finance charge when the APR is not required on small transactions.
- Open end credit
- The minimum periodic payment required and the method of determining any larger required periodic payment.
- The method of determining the balance upon which a finance charge may be imposed.
- The periodic rate(s).
- The annual percentage rate(s).

Sections 143 and 144 of the Truth in Lending Act be amended to make clear that there may be no expression of a rate in an advertisement of closed end credit other than the annual percentage rate as defined in the Truth in Lending Act and regulation Z.

Legislation be adopted to permit private suits seeking injunctive relief to false or misleading advertising.

The Truth in Lending Act be amended to provide that the Act and regulation Z apply to oral disclosures.

State laws which are inconsistent with the Federal Truth in Lending Act or which require disclosures which might tend to confuse the consumer or contradict, obscure, or detract attention from the disclosures required by the Truth in Lending Act and regulation Z be preempted by the federal law.

The Truth in Lending Act be amended as necessary to assure that subsequent assignees are held equally liable with the original creditor when violations of the Truth in Lending Act are evident on the face of the agreement or disclosure statement; and that there be equal enforcement by all appropriate agencies of this provision concerning assignees and all other Truth in Lending Act provisions in order to assure equal protection to all consumers.

Both suggestions of the Board of Governors of the Federal Reserve System pertaining to class action suits and the clarification of the definition of "transactions" be adopted.

The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act specifically to include under Section 125 security interests that arise by operation of law.

The Commission supports the recommendation of the Board of Governors of the Federal Reserve System that Congress amend the Truth in Lending Act to limit the time the right of rescission may run where the creditor has failed to give proper disclosures.

## Education (Chapter 11)

The Commission recommends that:

Congress support the development of improved curricula to prepare consumers for participation in the marketplace, with adequate attention to consumer credit as one aspect of family budgeting.

Appropriate federal and state agencies should continue their emphasis on adult education for low income consumers, try to reach more of them, and develop useful programs for the elderly,

Federal resources be used to encourage expanded research and carefully monitored pilot projects to generate and test new ideas in adult consumer education.

Business organizations support and encourage nonprofit credit counseling, provided it is conducted for the benefit of the consumer and does not serve solely or primarily as a collection agency.

If private debt adjusting services are allowed to continue, their activities be strictly regulated and supervised, including their fees and advertising.

Counseling be made a mandatory requirement for obtaining a discharge in both Chapter XIII and straight bankruptcy, unless the counselor in a particular case should determine that counseling would be unnecessary or futile.

## The Future of Consumer Credit (Chapter 12)

The Commission recommends that legislation be enacted to achieve the following goals:

1. Each consumer's complaint should be promptly acknowledged by the creditor.
2. Within a reasonable period of time a creditor should either explain to the consumer why he believes the account was accurately shown in the billing statement or correct the account.
3. During the interval between acknowledgment of the complaint and action to resolve the problem, the consumer should be free of harassment to pay the disputed amount.

4. The penalties on creditors for failure to comply should be sufficiently severe to prompt compliance.

The Commission recommends additional federal and state legislation specifically prohibiting any regulatory agencies from establishing minimum merchant discounts.

The Commission also recommends that studies be undertaken now to consider the eventual federal chartering and regulation of credit reporting agencies, both to assure the accuracy and confidentiality of their credit information and to achieve open and economical access to their data.

## CHAPTER 1, APPENDIX B:

# Listing of the membership, foreword, staff, and published technical studies of the National Commission on Consumer Finance

## Members of the Commission

### Appointed by the President:

Ira M. Millstein, Chairman

Attorney

New York, New York

Appointed Chairman January 20, 1971

to succeed Robert Braucher

Dr. Robert W. Johnson

Professor, Purdue University

Lafayette, Indiana

Hon. Douglas M. Head

Attorney

Minneapolis, Minnesota

Appointed February 16, 1971



## Appointed by the President of the Senate:

Hon. John Sparkman  
Senator from Alabama

Hon. William Proxmire  
Senator from Wisconsin

Hon. William E. Brock  
Senator from Tennessee

Appointed April 5, 1971 to succeed  
Hon. John G. Tower  
Senator from Texas

## Appointed by the Speaker of the House of Representatives:

Hon. Leonor K. Sullivan  
Representative from Missouri

Hon. Henry B. Gonzalez  
Representative from Texas

Appointed March 10, 1971 to succeed  
Hon. Wright Patman  
Representative from Texas

Hon. Lawrence G. Williams  
Representative from Pennsylvania

Appointed March 10, 1971 to succeed  
Hon. Seymour Halpern  
Representative from New York

# The Commission's Foreword

The National Commission on Consumer Finance, established by Title IV of the Consumer Credit Protection Act of 1968 (Public Law 90-321), attained its full membership on November 7, 1969 when the President named three public members and designated one of them Chairman.

As originally constituted, Commission members included Robert Braucher, professor of law at Harvard University, who was named Chairman; Robert W. Johnson, professor of finance at Purdue University; and Ira M. Millstein, member of the New York Bar, Presidential appointees; Senator John J. Sparkman, Senator William Proxmire, and Senator John G. Tower, Senate appointees; and Representative Wright Patman, Representative Leonor K. Sullivan, and Representative Seymour Halpern, House of Representatives appointees. When Chairman Braucher subsequently became an Associate Justice of the Supreme Judicial Court of Massachusetts, the President designated Mr. Millstein as Commission Chairman and named Douglas M. Head, former Attorney General for the State of Minnesota, to fill the vacancy. Later, when Senator Tower found it necessary to resign, he was replaced by Senator William E. Brock, and when Representatives Patman and Halpern also found it necessary to relinquish membership, they were replaced by Representative Henry B. Gonzalez and Representative Lawrence G. Williams. Despite these membership changes, however, a majority of the members and the Commission's executive director, Robert L. Meade, have served during the Commission's entire existence. Continuity was further achieved through monthly meetings and frequent written communications.

In a consumer message to Congress on October 30, 1969 President Nixon noted that total consumer credit outstanding had grown during the last 25 years from \$5.7 billion to \$100 billion and that Government supervision and regulation of consumer credit had become increasingly complex and difficult. The Commission, he said, "should begin its important work immediately."

Because of the wide area such a comprehensive subject could encompass, the Commission had to narrow the scope of its work to fit its funding and time limitations. Even so, the Commission twice had to ask Congress for additional time and once for additional funds. Certainly due in no small part to the interest, understanding, and generosity of the Congress, the Commission now offers this final Report to fulfill its Congressional mandate.

The Commission is confident that it has pioneered in collecting and presenting heretofore unobtainable data and ground-breaking studies and analyses. In and of themselves, the collection and dissemination of these data, the studies, and the analyses will provide a fresh and empirical basis for legislators, the industry, and scholars to consider.

Many of the supporting studies are being published as supplements to the final report for the use of legislators, the industry, scholars, and others interested in the basic data. Unpublished

data and studies as well as computer tapes can be read at the records center of the National Archives and Records Service, Washington, D.C.

As to the findings, conclusions, and recommendations contained in the report, these were prepared by the Commission staff based upon the data, studies, and analyses collected by the Commission and, more importantly, based upon the numerous meetings of the Commission throughout its life at which all the Commissioners had the opportunity to present their respective views as the work progressed. As in any report of this nature, not all of the Commissioners agreed with all of the findings, conclusions, and recommendations, as evidenced by the separate views expressed by the individual members, which separate views follow the body of the report.

During the course of its study, the Commission held three public hearings in Washington, D.C. to obtain facts and views from individuals, consumer organizations, industry, and Government on the subjects of debt collection practices, responsibility for enforcement of consumer credit protection laws, and the availability of consumer credit to women. The Commission publicly acknowledges its gratitude to witnesses who appeared at the hearings to provide invaluable information related to ever increasing complexities in the consumer credit field. The Commission also notes its gratitude to thousands of credit industry officials who spent hours of time and effort in completing Commission questionnaires which provided priceless data. Obviously, their assistance in providing data does not necessarily indicate their concurrence with the report and its recommendations.

Although this report is directed to the President and to the Congress, the Commission hopes that consumers, the consumer credit industry, state legislative bodies, and professional and academic communities will also find that it adds substantially to their understanding of a growing industry and a complex subject.

# Staff of the National Commission on Consumer Finance

## STAFF OF THE COMMISSION

Robert L. Meade  
*Executive Director*

Ruth K. Holstein  
*Public Information Officer*

Donald B. Harper  
*Administrative Officer*

### Legal

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*General Counsel*

Stephen M. Crane<sup>1</sup>

Alan R. Feldman  
*Counsel*

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<sup>1</sup> Until February 5, 1972

<sup>2</sup> Until September 4, 1971

<sup>3</sup> Until November 3, 1971

# Technical studies of the National Commission on Consumer Finance

The studies listed below are being published by the Commission and copies may be ordered from the Government Printing Office, Washington, D.C. 20401. Publication by the Commission does not imply its approval, but in many instances Commission findings, conclusions, and recommendations are, in part, based on the studies.

## VOLUME I

1. Robert P. Shay and Milton W. Schober.

Consumer Awareness of Annual Percentage Rates of Charge in Consumer Instalment Credit: Before and After Truth in Lending Became Effective.

2. George S. Day and William K. Brandt.

A Study of Consumer Credit Decisions: Implications for Present and Prospective Legislation.

3. Terry Deutscher.

Credit Legislation Two Years Out: Awareness Changes and Behavioral Effects of Differential Awareness Levels.

## VOLUME II

1. George J. Benston.

The Costs of Extending Consumer Credit at Consumer Finance Companies and Commercial Banks.

2. George J. Benston.

Continuous High Interest Rate Borrowing and Consumer Welfare: An Analysis of Maine's "36 Months Limitation" on Finance Company Small Loans.

3. Thomas A. Durkin.

A High-Rate Market for Consumer Loans: The Small Small Loan Industry in Texas.

4. Thomas F. Cargill.

Performance of Limited-Income Credit Unions: 1969-1970.

## VOLUME III

Robert P. Shay and Milton W. Schober.

A Statistical Compilation of Credit Rates, Extensions, and Outstandings in Consumer Credit Markets in the United States in 1971.

## VOLUME IV

Edited by Douglas F. Greer and Robert P. Shay.

An Econometric Analysis of the Consumer Credit Market in the United States in 1971.

### Part I:

1. Douglas F. Greer.

A Theory of Credit Rationing.

2. Douglas F. Greer and Robert P. Shay.

Preliminary Model Specifications for the Personal Loan Market.

3. Douglas F. Greer and Robert P. Shay.

Preliminary Model Specifications for the New Automobile Credit Market.

4. Douglas F. Greer and Robert P. Shay.

Preliminary Model Specifications for Other Consumer Goods Credit Market.

5. Ernest A. Nagata and Douglas F. Greer.

Preliminary Model Specifications for Mobile Home Credit Market.

### Part II:

1. Douglas F. Greer.

An Empirical Analysis of the Personal Loan Market.

2. Douglas F. Greer and Ernest A. Nagata.

An Empirical Analysis of the New Automobile Credit Market.

3. Ernest A. Nagata and Douglas F. Greer.

An Empirical Analysis of Other Consumer Goods Credit.

4. Ernest A. Nagata and Douglas F. Greer.

An Empirical Analysis of the Mobile Home Credit Market.

5. Robert P. Shay.

The Impact of State Legal Rate Ceilings upon the Availability and Price of Consumer Instalment Credit.

6. Richard K. Slater and Douglas F. Greer.

The Role of Finance Income in Gross Profit Margins of Automobile Dealers.

## VOLUME V

Alan R. Feldman and Douglas F. Greer.

Creditors' Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections.

## VOLUME VI

1. William C. Dunkelberg.

An Analysis of the Impact of Rate Regulation in the Consumer Credit Industry.

2. Paul F. Smith .

The Status of Competition in Consumer Credit Markets.

The studies listed below and prepared for the Commission may be perused at the Records Center of the National Archives and Records Service, Washington, D.C.:

1. Gary G. Chandler.

An Analysis of the Debt Positions of Poverty Area Families

2. Ronda F. Paul.

A Study of Credit Granting Systems for Low-Income Consumers.

3. Darrell A. McNabb.

An Inquiry into the Response of Durable Goods Retailers to a Reduction in the Statutory Ceiling on Consumer Credit Charges.

4. Stephen M. Crane.

A Study of Deficiency Suits for Automobile Credit Transactions in the District of Columbia.

5. Milton W. Schober.

A Study of the Costs of Extending Retail Sales Credit.

6. Sylvia Lane.

An Analysis of Credit Counseling Programs.

## CHAPTER 1, APPENDIX C:

# Listing of Members and staff of the Taskforce on Federal Consumer Financial Law

## Members of the Taskforce

Todd J. Zywicki, J.D.  
Taskforce Chair, CFPB  
Professor of Law, George Mason University

J. Howard Beales, Ph.D.  
Taskforce Member, CFPB  
Emeritus Professor, George Washington University  
Formerly Director, Bureau of Consumer Protection, Federal Trade Commission

Thomas A. Durkin, Ph.D.  
Taskforce Member, CFPB  
Senior Economist (Retired), Board of Governors of the Federal Reserve System

William C. MacLeod, J.D.  
Taskforce Member, CFPB  
Attorney  
Formerly Director, Bureau of Consumer Protection, Federal Trade Commission

L. Jean Noonan, J.D.  
Taskforce Member, CFPB  
Attorney  
Formerly General Counsel, Farm Credit Administration



# Staff of the Taskforce

Nathaniel J. Weber, Staff Director

Gregory Elliehausen, Chief Economist

David H. Hixson, Senior Counsel

Jeffrey S. Magliato, Paralegal

Alexander K. Nongard, Director's Financial Analyst

Ross Rutledge, Economist and Senior Advisor

Ashlie N. Tarpley, Senior Counsel

## 2. Extent and growth of consumer credit

Credit use by individuals is certainly not a 21st century phenomenon; it actually is as old as recorded human history and probably much older. Credit use is known from the Bible, ancient India and Babylon, the Greek city states, the Roman Republic, and medieval Europe. It may well have originated in Neolithic times when individuals down on their luck needed help with necessities. Biblical prohibitions on taking advantage of brothers in need by charging them for credit argued for centuries the influential religious view that the absence of charity in such situations was sinful.<sup>1</sup> Civil restrictions on credit use likewise are ancient.

### 2.1 Development of Modern Consumer Credit

But before the 20th century, absence of what today are common consumer goods and services like automobiles, appliances, recreational durable goods, commercial home-improvement services, and widespread higher education precluded the need or desire for much of today's phenomenon of consumer credit. In the more distant past, credit use by individuals for noncommercial purposes probably most often did reflect necessitous situations where charity was another possible answer.

History shows, however, that use of credit by artisans and tradespeople also flourished in ancient times, and that it was subject to the same kinds of religious and civil regulatory prohibitions as necessitous credit in the European Middle Ages. This thinking began to change in the later Middle Ages with the spread of trading economies. At the time, merchants often needed to acquire trade goods on credit for resale, but changes in religious views about credit use still took centuries. Even then, it took more centuries for evolving beliefs to move beyond business and trade-related credit to other credit for individuals.

Religious opposition to lending at interest gradually faded with development of more robust commerce and trade during the Renaissance/Reformation/Enlightenment centuries and later, but it seems like widespread cultural and governmental anxiety over personal lending and

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<sup>1</sup>See *Exodus* 22:25, *Leviticus* 25:35-37, and *Deuteronomy* 23:19-20.

borrowing has never completely gone away, even as secularization of economic and commercial affairs has advanced. At least some of modern governmental concerns over consumer credit appear to arise from society's remaining basic ambivalence about whether credit use by individuals is good for them or not, perhaps a modern vestige of the ancient and medieval view that lending is questionable or even immoral. Modern economic analysis has shown that there are many situations where credit use is beneficial to consumers (see Chapter 3), but the issue is still not settled completely to the satisfaction of everyone. Nonetheless, it is obvious that there has been a strong, long-term trend toward greater acceptability of credit use by individuals as a feature of modern life.<sup>2</sup>

Domestically in what became the United States, from colonial times through the 1850s there was credit use but mostly as a substitute for circulating coin money that often was in short supply or for what we would today consider business purposes. Farmers as producers, for example, borrowed to acquire land for crops. As consumers, they also often purchased shop goods on credit while they waited for the harvest and the barter or sale of farm goods to repay the merchants. Artisans of various sorts also extended credit if they, like the shopkeepers, were to sell their services and be paid at all. Promissory notes and similar documents often circulated like money. This kind of credit system lasted for many years in many places.<sup>3</sup>

But it was the coming of urbanization and expansion of town and city dwelling and the accompanying middle class after the Civil War, along with the invention of new consumer goods such as automobiles and electrical appliances somewhat later, which led to the modern phenomenon of consumer credit that is so familiar today. Although there always have been necessitous loans in the absence of sufficient charity and other economic relief, there simply was little need before the 1920s for the auto loans, boat loans, durable goods credit, college tuition credit, and home modernization and repair loans that make up the bulk of consumer credit use today. The interwar years saw considerable growth of consumer credit, but most of the expansion came in the years after World War II. As indicated, the reasons for credit use and growth are explored further in Chapter 3.

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<sup>2</sup>For extended discussion of ancient and medieval views of credit and its regulation and the impact of the Enlightenment, see SIDNEY HOMER AND RICHARD E. SYLLA, *A HISTORY OF INTEREST RATES* (New Brunswick, NJ: Rutgers University Press, 1999) and ROSA-MARIA GELPI AND FRANCOISE JULIEN-LABRUYERE, *THE HISTORY OF CONSUMER CREDIT* (New York: St. Martin's, 2000). See also Paul B. Rasor, *Biblical Roots of Modern Consumer Credit Law*, 10 *Journal of Law and Religion* 157–192 (1993).

<sup>3</sup>For colorful examples and extended review of credit use (and other activities) in the early nineteenth century by frontiersman and politician David Crockett, land speculator James Bowie, and lawyer William B. Travis, all of whom lost their lives and their debts at the Alamo in 1836, see WILLIAM C. DAVIS, *THREE ROADS TO THE ALAMO: THE LIVES AND FORTUNES OF DAVID CROCKETT, JAMES BOWIE, AND WILLIAM BARRET TRAVIS* (New York: HarperCollins, 1998).

Credit regulation expanded with the development of credit for individuals. From ancient times to the early 20th century, credit regulation consisted mostly of interest-rate limits. Rate ceilings reflected the historical, religious, and social prohibitions against benefitting from the difficulties of others. But rate ceilings also made extensions of small amounts of credit to necessitous or other consumer-borrowers unprofitable for existing commercial-lending enterprises like banks as economic life secularized. Rate ceilings at the state level persisted in the United States as the economy began to modernize after the Civil War, preventing the lending of small amounts of credit for individuals. (At the time, virtually all credit regulation in the United States was at the state or local level.) This did not extinguish the need for emergency credit during these years, however. At the time, many individuals in the newly urbanized segments of the population, now often disbursed from their extended families, obtained credit from lenders operating outside the state laws. The post-Civil War period in the United States up to about 1915 has subsequently become known as the “illegal lending” or “loan shark” period of consumer credit.<sup>4</sup>

Beginning about 1910, reformers and commercial enterprises took aim both at the prevalence of loan-shark providers of necessitous credit and the developing opportunities to aid in the sale of new consumer goods and services profitably. Both sorts of effort led to the spread of new kinds of consumer-lending institutions.

Reform efforts of the Russell Sage Foundation beginning in October 1910 led first to supporting semi-philanthropic lenders, also known as “remedial lenders” and “remedial pawn shops.” These lenders would use philanthropic capital and lend using fair but business-like methods. By 1916, the reform-oriented Sage Foundation determined that this approach was insufficient to address the loan-shark problem due to inability of the semi-philanthropic lenders to attract sufficient lending capital. Consequently, the foundation joined forces with willing commercial lenders to sponsor legislation in the states enabling formation of state-regulated cash lenders of small amounts. These lenders would operate under legislated exceptions to each state’s overarching rate-ceiling requirement, permitting higher but regulated rates for this purpose.

At the time, lenders based upon the Sage Foundation reforms and related state-regulation efforts were known as small-loan companies or licensed lenders. They still exist today in some states as the traditional installment-lending industry. An important event took place in 1932 when New York Governor Franklin D. Roosevelt requested that the legislature of the most populous state pass the reform legislation, which it did unanimously in both houses. By the

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<sup>4</sup>For further discussion of credit use and difficulties during these years, see LOUIS N. ROBINSON AND ROLF NUGENT, *THE REGULATION OF THE SMALL LOAN BUSINESS* (New York: Russell Sage Foundation, 1935); see also IRVING S. MICHELMAN, *CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS* (New York: Augustus M. Kelley, 1970); see also HOMER AND SYLLA, *A HISTORY OF INTEREST RATES*, op. cit.; LENDOL C. CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* (Princeton, NJ: Princeton University Press, 1999); GELPI AND JULIEN-LABRUERE, *THE HISTORY OF CONSUMER CREDIT*, op. cit.; and ANNE FLEMING, *CITY OF DEBTORS* (Cambridge, MA: Harvard University Press, 2018).

1960s, laws based upon the Russell Sage Foundation's efforts existed in almost every state. Since then, changes in or inattention to updating legal requirements as inflation and other economic changes have ensued mean these lenders have become archaic and attenuated or absent in many states, although they still exist in others.

The decade of the 1910s also witnessed formation of other kinds of consumer lenders. They included credit unions, similar in basic intent to those still operating as cooperatives today, although more primitive and smaller than the modern ones.<sup>5</sup> "Industrial workers' banks" that operated under a complicated lending plan to get around rate ceilings and offer installment credit to industrial workers, known as the Morris Plan, were another new kind of institution. A Virginian named Arthur Morris opened the first Morris Plan Bank in Norfolk in 1910.<sup>6</sup>

As a practical matter, the Morris Plan banks amounted to finance companies that took deposits. Their lending plan became the forerunner of consumer lending by the commercial banking industry, but commercial banks did not enter the field until the late 1920s and then only tentatively. Most of the growth in bank consumer lending occurred after World War II. In 1951, the Franklin National Bank of New York became the first bank to issue bank credit cards. Morris Plan banks and commercial banks making consumer loans eventually became subject to their own sets of state regulations, including further exceptions to state-based rate ceilings specifically put in place for them. Many of the old Morris Plan banks and loan companies later evolved into commercial banks.

The 1910-1920 period also saw early finance companies formed to facilitate the sales of the merchandise of related manufacturers. The manufacturers came to believe they could sell a lot more output if they also financed the sale. For example, the General Motors Company formed the General Motors Acceptance Corporation (GMAC) in 1919 to aid the sales of the parent. Many consumers took advantage of the opportunity to acquire this new consumer durable good and use it immediately.<sup>7</sup> Over time, GMAC became the largest finance company in the world. (Today, a remnant survives as Ally Bank, no longer a subsidiary of General Motors.) Other manufacturers also formed sales-finance subsidiaries, often known then and now as "captives." Today, independent companies also finance sales, including new and used cars, motorcycles,

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<sup>5</sup>The first US credit union was established in New Hampshire in 1909, but credit unions did not spread beyond a few eastern states until the 1920s.

<sup>6</sup>The Morris plan allowed banks to make small loans profitably under existing laws. The Morris plan loan charged a legal rate of interest but collected interest at origination out of the loan principal. The bank obtained additional funding by requiring the borrower to purchase non-interest-bearing certificates. The borrower's payments were credited to purchase of the certificates, not to reducing the loan principal. When the required certificate purchases were completed, the certificate was cancelled, with the proceeds from the cancellation being used to repay the loan.

<sup>7</sup>The early development of automobile financing and its important role in spurring competition in car manufacturing and making automobiles accessible to ordinary Americans is discussed in Chapter 9.

recreational vehicles, mobile homes, boats, and aircraft. In addition, there are many business-lending finance companies.

Regulation of these sales-finance firms was different from small-loan finance companies. Courts decided that financing a specific sale was not a loan for regulatory purposes. Rather, these were sales of goods “on time” and not loans of money that triggered lending laws. Under this conception, the difference between the price of a sale for cash today and the total price over time (called the “time-price differential”) was not interest and not subject to state interest-rate ceilings.<sup>8</sup> The same thinking applied to consumer financing by retail stores and dealers. Eventually, most states also regulated time-price differentials.

Consequently, all these institutions came under a range of different state laws and regulations. Small-loan companies were regulated under versions of the Uniform Small Loan Law, sponsored by the reform-minded Russel Sage Foundation, and in some states also by other laws legislated for larger loans. Morris Plan lenders, many of which later became banks, were regulated under laws specifically for such lenders and banks. Credit unions had their own laws. So did the sales finance companies and retail outlets regulated by sales finance codes often known as “all goods” acts. In 1972, the National Commission on Consumer Finance (NCCF) complained about the range and sometimes Byzantine interaction of all these laws regulating types of credit, loan sizes, and institutions differently as barriers to effective competition in markets for consumer credit.

Referring to Barbara A. Curran’s 1965 compilation of state laws, the NCCF wrote in its *Report* in 1972 (p. 94):

A compilation of consumer credit legislation reveals the present hodgepodge of legislation characteristic of most states. As one example, New York has separate statutes regulating installment loans by commercial banks, loans by industrial banks, bank check-credit plans, revolving charge accounts, motor vehicle installment sales financing, installment financing of other goods and services, insurance premium financing, loans by consumer finance companies, and loans by credit unions. The general usury rate is 6 percent (currently 7 1/2 percent under special rule of the Banking Board), and criminal penalties apply if interest is over 25 percent [footnote omitted]. But the decreed maximum rates to obtain \$500 of credit, repayable monthly over 12 months, range widely: bank personal and improvement loans, 11.6 percent; industrial banks, 14.5 percent; used cars up to 2 years old, 17.7 percent; used cars over 2 years old, 23.2 percent; small-loan companies, 24.8 percent; other goods, 18.0

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<sup>8</sup>See *Hogg v. Ruffner*, 66 U.S 115 (1861).

percent; retail revolving credit 1 1/2 percent on monthly balances up to \$500 and 1 percent monthly on balances in excess of \$500.

The variety of rate ceilings that has developed on an *ad hoc* basis creates barriers to competition among segments of the consumer credit industry. Given a maximum rate of 11.6 percent in New York, commercial banks will not enter the \$500-loan market served by consumer finance companies at 24.8 percent.<sup>9</sup>

The regulatory trend since the NCCF's time has generally been in the direction of homogenization of laws and regulatory regimes affecting consumer credit. On balance, states have tended to adjust their credit laws in the direction of greater consistency of regulation across the classes of lenders and lending within their boundaries. There is still diversity within states and considerable diversity among states, however.

Eventual federal legislation is a bit more focused within its spheres of activity: Beginning with the Truth in Lending Act in 1968, the Fair Credit Reporting Act in 1970, and the Equal Credit Opportunity Act in 1974 and 1976, federal rules for the most part apply to all consumer creditors in the same way. Later in 2010, the Dodd-Frank Act established the Consumer Financial Protection Bureau to be a consistent federal voice in consumer credit with ongoing responsibilities.

Despite partial homogenization and federal regulatory entry, regulatory overlaps and difficulties remain, however. There still are differences in regulation among states and sometimes within them. Now there is also an ongoing federal presence that raises further questions of overlapping jurisdictions, including questions of the desirability, or not, of federal preemptions of state laws. These jurisdiction issues are discussed further later in this report, especially in Chapters 6 and 13.

## 2.2 Consumer Credit Growth

Consumer credit certainly *seems* important today. As indicated in Chapter 1, domestic consumer credit outstanding (exclusive of mortgage credit) rose from about \$6.8 billion at the end of 1945 and wartime restrictions (about \$99 billion in 2019 dollars) to \$4.2 trillion at the end of 2019. This section of this chapter outlines the types of consumer credit in widespread use today and briefly reviews aspects of their growth over the decades. Chapter 3 then discusses further the

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<sup>9</sup>Note: Bank credit cards were a lot less common at that time than more recently, but they also had rate ceilings.

meaning of “types of credit” and why certain types of credit account for much of the consumer credit extended.

In 1972, the NCCF provided an examination of consumer credit outstanding at the time and its growth since World War II in its Chapter 2. The NCCF was able to employ statistics on consumer credit continuously collected by the Federal Reserve since 1943, the same ongoing statistical series used here. The Federal Reserve’s data collection effort began when federal wartime restrictions on both consumer goods production and consumer credit use on account of inflationary concerns made consumer credit a federal policy matter for the first time (Regulation W, see footnote in Chapter 1 of this report).

As consumer credit grew in the postwar years, the Federal Reserve Board has maintained this data collection, updating and revising it as credit types and markets changed over time (see Federal Reserve monthly statistical release “Consumer Credit - G19” and the historical series underlying it). After the war, the Federal Reserve also began its program of collecting information about the distributions of assets and debt among the public through the Surveys of Consumer Finances program that also extends to the present. The Surveys of Consumer Finances were begun by the Survey Research Center of the University of Michigan in 1946 with the support of the Federal Reserve and others in later years. Since 1992, the National Opinion Research Corporation of the University of Chicago has undertaken the survey field work.

Modern consumer credit is diverse enough that it can be classified in many ways. In recent years, the Federal Reserve has divided the totals in three ways: The first is by the means that credit is generated and repaid (nonrevolving versus revolving credit). The second is by institutional source of the funds (eight kinds of institutions in recent years, reduced to seven through a combination of certain statistics after mid-2020). Since 2013, the Federal Reserve has also released statistics a third way, according to two uses of consumer loans: automobile credit (including consumer trucks and motorcycles but not consumer leases) and student loans. The separate figures by purpose extend back to 1943 for auto credit and to 2006 for student loans. The following paragraphs highlight some of the Federal Reserve’s statistical information on consumer credit.<sup>10</sup>

The first grouping of consumer credit amounts outstanding is by method of credit advance and repayment (upper part of Table 2-1 for current dollars and middle part of the table for 2019 dollars). Two methods of advance and repayment are widespread today. The first is

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<sup>10</sup>In their 2014 book, Durkin, Elliehausen, Staten, and Zywicki examine the background and changing kinds of statistics and components of consumer credit in the postwar period in considerably more detail than attempted here. They also examine credit growth itself in much more detail. See THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI, *CONSUMER CREDIT AND THE AMERICAN ECONOMY* (New York: Oxford University Press, 2014), Chapters 1 and 2.



nonrevolving credit, where the amount of the credit advance and the size and timing of repayments are determined in advance by contract (for instance, automobile credit). In terminology used by Truth in Lending, this kind of credit is also known as “other than open-end” consumer credit, or more familiarly as “closed end” consumer credit.

**TABLE 2-1: CONSUMER CREDIT OUTSTANDING, END OF SELECTED YEARS, 1945-2019**

	1945	1955	1965	1975	1985	1995	2005	2010	2015	2019
Billions of Current Dollars										
By Type of Credit										
Nonrevolving	7	43	97	192	479	703	1464	1808	2504	3097
Revolving				15	132	465	857	839	907	1094
Total	7	43	97	207	611	1168	2321	2647	3411	4191
By Type of Institution										
Depository Institutions	3	19	49	116	355	542	816	1186	1428	1771
Finance companies	1	12	24	33	112	152	517	705	561	537
Credit unions	*	1	6	26	74	132	229	226	342	482
Nonfinancial business	3	11	18	33	63	85	60	44	38	40
Pools of securitized assets						213	610	50	46	14
Federal government <sup>1</sup>					7	44	90	364	950	1319
Nonprofit and educational inst. <sup>2</sup>								71	45	28
Total	7	43	97	207	611	1168	2321	2647	3411	4191
	1945	1955	1965	1975	1985	1995	2005	2010	2015	2019
Billions of 2019 Dollars										
By Type of Credit										
Nonrevolving	99	410	787	912	1138	1179	1916	2120	2700	3097
Revolving				71	314	780	1122	984	978	1094
Total	99	410	787	983	1452	1959	3039	3103	3679	4191
By Type of Institution										
Depository Institutions	43	181	398	551	843	909	1068	1391	1540	1771
Finance companies	14	114	195	154	266	255	676	827	605	537
Credit unions	*	10	49	124	176	221	300	265	369	482
Nonfinancial business	43	105	146	153	150	143	78	52	41	40
Pools of securitized assets						357	799	59	50	14
Federal government <sup>1</sup>					17	74	118	427	1025	1319
Nonprofit and educational inst. <sup>2</sup>								83	49	28
Total	99	410	787	983	1452	1959	3039	3103	3679	4191

	1945	1955	1965	1975	1985	1995	2005	2010	2015	2019
Percent of Total Consumer Credit (Current and Constant Dollars)										
By Type of Credit										
Revolving				7	22	40	37	32	27	26
Nonrevolving	100	100	100	93	78	60	63	68	73	74
Total	100	100	100	100	100	100	100	100	100	100
By Use of Credit										
Motor vehicles	7	31	30	28	35	31	35	27	29	28
Federal student loans <sup>1,2</sup>					1	4	4	16	29	32
"Other"	93	69	70	72	43	25	24	25	15	13
Total	100	100	100	100	100	100	100	100	100	100

Source: Federal Reserve Statistical Release G19, "Consumer Credit," Historical Data. Figures shown are for December, not seasonally adjusted. Columns may not add exactly to totals because of rounding.

\* Greater than zero but less than one half billion.

<sup>1</sup>Includes student loans originated by the Department of Education under the Federal Direct Loan Program and the Perkins Loan Program, as well as Federal Family Education Program loans that the government purchases under the Ensuring Continued Access to Student Loans Act.

<sup>2</sup>Includes student loans originated under the Federal Family Education Loan Program and held by educational institutions and nonprofit organizations. Federal student loans in this panel of the table do not include student loans made by private sources and included within totals for depository institutions and finance companies that are in "other" loans.

The second method of advance and repayment is revolving credit, where both the amount and timing of the advance and the amount of monthly repayment are decided upon by the consumer, subject to a maximum credit size and some minimum monthly payment amount (for example, credit-card credit which is the bulk of this kind of credit). This kind of credit is also widely called "open-end" consumer credit. Before 1968, the Federal Reserve did not make the distinction in the statistical series between nonrevolving and revolving credit (closed and open-end credit), but the growing innovation of the three-party credit card at around that time (consumer, merchant, and financial institution) and passage of Truth in Lending that year that made this distinction argued for this new classification.<sup>11</sup> Revolving or open-end forms of consumer credit today account for about a quarter of the total. Nonrevolving or closed-end forms of consumer credit account for about three-quarters of consumer credit today, about \$3 trillion at present.

An alternative way of grouping consumer credit is according to institutional source of the credit (lower portion of the top and middle panels of Table 2-1). The listed institutions are the ultimate lenders of the amounts (for instance, depository institutions and finance companies). They are not necessarily the same institution with whom the consumer actually originates the transaction and takes on the obligation (such as finance offices of automobile dealers or colleges).

<sup>11</sup>The term "three-party credit card" (consumer, merchant, and financial institution that issues the card to the consumer), a term in use since the originator known as the Diners Club in the early 1950s, refers to the consumer side of this transaction. It should not be confused with the three or four-party processing networks that manage the electronic processing of the transaction among merchants, banks, and their electronic settlement networks.

Frequently, originating lenders sell the promissory notes to the ultimate lenders shortly after closing of the originating transaction, a procedure called “indirect credit.”

The largest suppliers of consumer credit are depository institutions, mostly commercial banks. Much of commercial bank consumer credit in recent years is through their credit card operations. Credit unions comprise their own group, although they also are depository institutions. The reason for making this particular distinction among depositories is to provide a bit more information about kinds of depositories but without also requiring separate groupings today for remaining other sorts of depositories that are now small in number. These others include savings banks and savings and loan associations, today lumped with commercial banks and referred to as “depository institutions.” Within the quarter of consumer credit that is revolving credit, depositories hold the lion’s share, mostly through their credit card programs using the American Express, Discover, MasterCard, and Visa brand names, the latter two names used by many separate depositories.

The fastest growing provider of consumer credit in recent years is the federal government. The growth in the federal government category reflects the recent expansion of a variety of federal student loan programs that have come to dominate educational lending. The federal government is now the second largest institutional source of consumer credit (Table 2-1). Some student loans are still made and held by other lending institutions like the former federal lending affiliate Sallie Mae (now a private depository institution). These other student loans are counted within the commercial banking and finance company sectors, but the bulk of student lending today is held by the federal government.

After depository institutions and the federal government, finance companies and credit unions are the remaining large institutional suppliers of consumer credit. The decline in the finance company category in recent years reflects the reclassification of federal loans formerly held by federal affiliate Sallie Mae that became a private company some years ago, from the finance company group then to the newer federal government category now.

Residual suppliers include nonprofit educational institutions (mostly colleges), nonfinancial businesses (like retail stores and auto dealers), and pools of securitized assets. The latter are consumer credit assets such as auto and credit card receivables (loans) that lenders form into pools supporting securities sold in worldwide financial markets. This method of obtaining the funding for consumer credit once was much larger than at present, until changes in accounting requirements a little over a decade ago required moving the assets back onto the books of the lender and making this method of obtaining funds for lending much less attractive (see table).<sup>12</sup> Recently, the amounts in this category have become small enough that the Federal Reserve

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<sup>12</sup>Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 167 (2009).

eliminated this category beginning in the second half of 2020; it is included in Table 2-1 because this lending source was very large only a few years ago and there is still some interest in what these amounts were.

The third panel of the Table 2-1 shows that within the components of nonrevolving consumer credit, motor-vehicle credit has remained around one-quarter to one-third of total consumer credit since the early years of the post-World War II period. In contrast, the innovation of revolving credit associated with three-party credit cards grew rapidly beginning in the 1960s, rising to 7 percent of consumer credit by 1975 and to 40 percent by 1995.

Looking further at the third panel of the table also shows that the three-party credit card was mostly a technological change that brought about replacement for much of “other” consumer credit in the form of credit for household durable goods, appliance, and repair credit. Formerly, individuals desiring to purchase televisions, carpeting, refrigerators and other household items using credit needed to visit the “credit department” of the store or dealer to arrange the financing. Much of this credit was provided by finance companies that purchased the loans from the retailers. Using this new form of revolving credit obviated this need in many cases and was much more convenient for consumers. This change is clear even in the aggregate statistics in the third panel of Table 2-1. The portion of “other” nonrevolving consumer credit dropped sharply 1965-1995 as revolving credit use grew.

Another important trend in the figures reflects the recent growing importance of federal student loans. The volume of these student loans has become great enough in recent years that the proportions of all the other kinds of consumer credit (revolving, vehicle, and “other”) have declined. More will be said about student loans in Chapter 12.

One of the questions that sometimes arise from the statistics on amounts of consumer credit in use is whether these totals have risen “too fast” or are now “too high.” This is an old area of economic inquiry and review that sometimes produces the responses “compared with what?” and “what is too high?” There are several ways of looking at these questions.

Durkin, Elliehausen, Staten, and Zywicki examined them at considerable length in 2014 and looked at past reviews by others of what had been known earlier as the “debt-burden” issue.<sup>13</sup> They also reviewed many studies undertaken in this area over the decades since World War II. They concluded that recent consumer-credit growth trends, after taking into account inflation and the growth of other economic variables such as income and assets, were much like those in

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<sup>13</sup>See Durkin, et al., *Consumer Credit and the American Economy*, op. cit. Chapter 2.

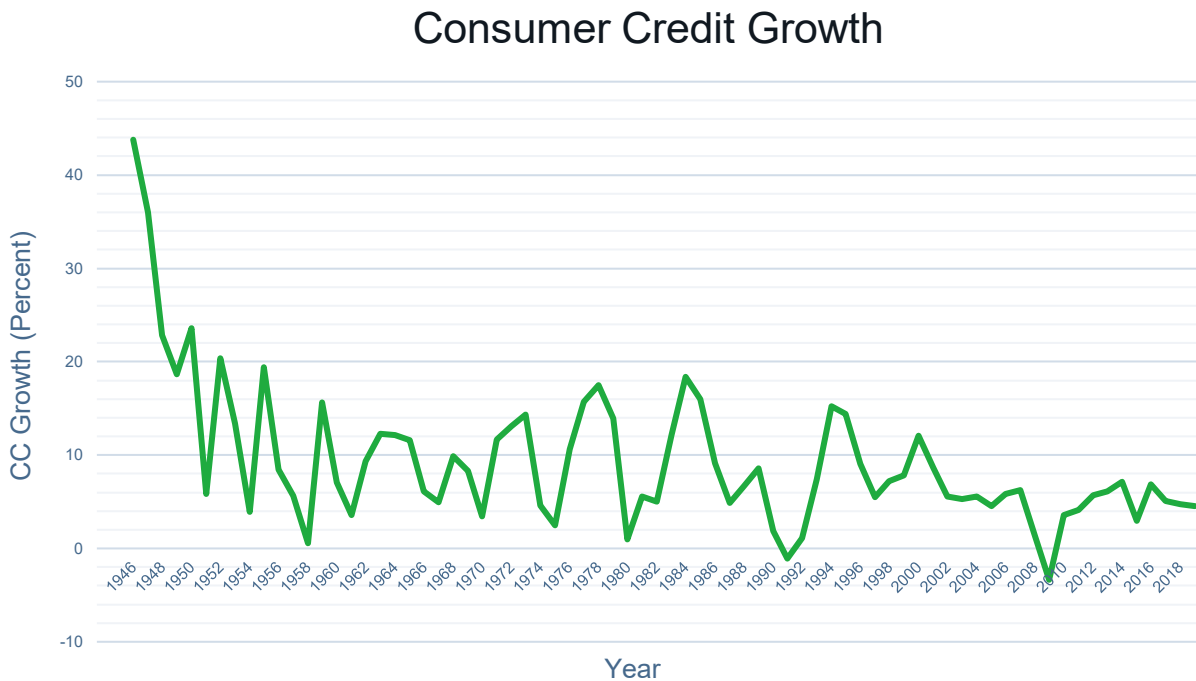
earlier periods, after rapid early postwar growth in the 1950s. Updating their tables and charts to the end of 2019 provides a largely similar assessment today.

As the NCCF suggested in 1972, one way of looking at consumer credit trends is to compare them with themselves; in other words, examining their growth rate over time. Does the growth rate of consumer credit exhibit a recent trend that looks out of the ordinary, or has growth changed recently in some substantial or significant way? Another is to compare consumer credit with the other important economic quantities mentioned: general inflation, income, and assets.

It turns out that the consumer-credit growth rate has always been cyclical, rising for some time after a recession before leveling out and then declining before the next recession approaches and occurs. The recent rapid decline in the consumer-credit growth rate associated with the COVID-19 recession in 2020 is consistent with previous recessionary declines typical in consumer-credit growth.

Growth experience in recent decades has been much like past experience on this measure (see Figure 2-1). The highest growth rates were in the late 1940s and early 1950s. The aggregate amounts of credit have become larger as the economy has experienced population and income growth (plus inflation) over the postwar period, but recent nominal growth rates of consumer credit have been well within experience of the past six decades. If not for student lending, consumer-credit growth over the recent decade would actually be lower recently than often typical in the past.

**FIGURE 2-1:** CONSUMER CREDIT GROWTH



## 2.3 Consumer Credit Growth and Means of Repayment

But consumer credit is not the only economic quantity to grow in the postwar period; employment, income, savings, and assets of the household sector also have grown. Perhaps more interesting than credit growth in isolation is to look at long-term consumer credit growth relative to the means of repayment: income and assets.

Consumer credit relative to household income rose rapidly in the years following World War II, the period that encompassed the greatest percentage rises in consumer credit historically. The increases at the time reflected a variety of important factors such as renewed availability of consumer durable goods like autos and appliances after the end of wartime production restrictions, but the growth rates then seem to have established a view in the press and elsewhere that consumer credit always grows relative to income.<sup>14</sup> Other factors included rising

<sup>14</sup>A number of economic analysts studied these trends in the early postwar period and concluded otherwise. Especially, see Alain Enthoven, *The Growth of Installment Credit and the Future of Prosperity*, American Economic

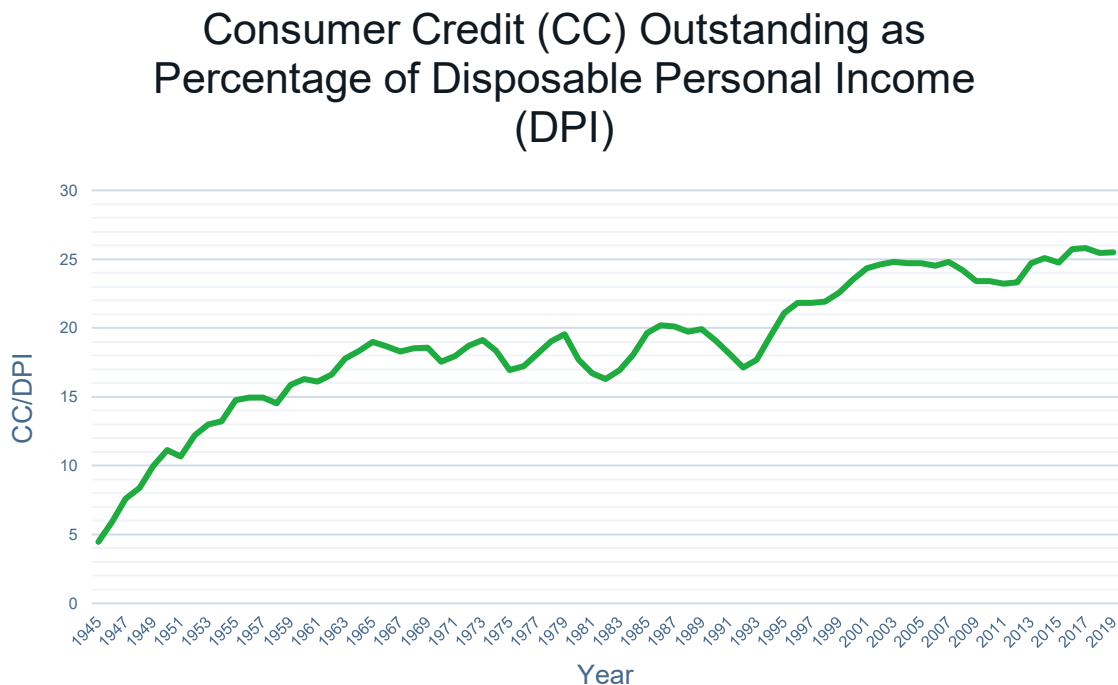
and more stable postwar income and prospects, as the Great Depression faded further into the past. Higher and more stable income allowed consumers to devote more discretionary resources to durable goods and their financing. The beginning of the sustained move to the suburbs was also important. With migration to the newly developing postwar subdivisions, demand increased for transportation assets, appliances, and furniture for the new suburban homes likely contributing to the increase in credit use at the time.

Figure 2-2 illustrates the long-term trend of total consumer credit relative to household disposable personal income (after-tax income) since World War II. The chart shows that after postwar growth from a low level, the trend in this ratio largely leveled out by 1963 followed by a slow upward trend afterward.

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Review, 47(6), 913 (1957); see also Helen Manning Hunter, *A Behavioral Model of the Long-Run Growth of Aggregate Consumer Credit in the United States*, Review of Economics and Statistics, 48(2), 124 (1966); Michael J. Prell, *The Long-Run Growth of Consumer Installment Credit – Some Observations*, Federal Reserve Bank of Kansas City Monthly Review, September, 1973; and Charles A. Lockett and James D. August, *The Growth of Consumer Debt*, Federal Reserve Bulletin 71, 389 (1985). For extended discussion of these and other studies on this question, see DURKIN, ET AL., CONSUMER CREDIT AND THE AMERICAN ECONOMY, op. cit. Chapter 2.

**FIGURE 2-2:** CONSUMER CREDIT (CC) OUTSTANDING AS PERCENTAGE OF DISPOSABLE PERSONAL INCOME (DPI)



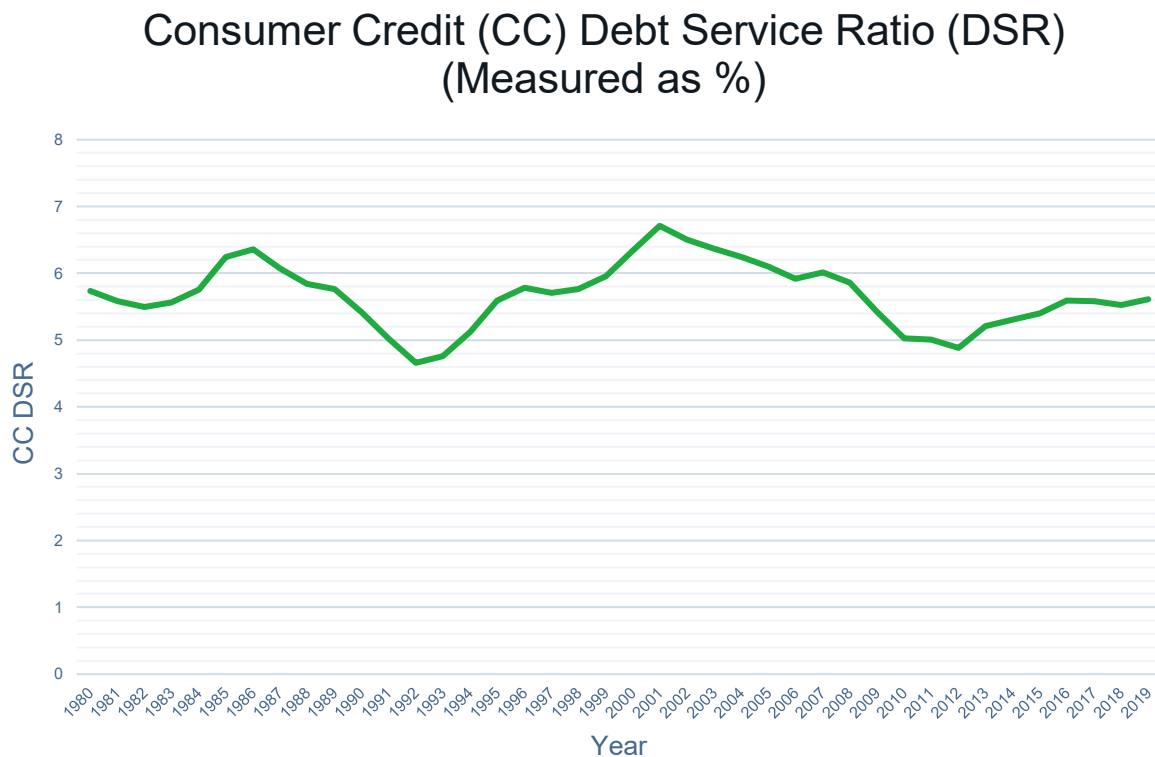
Although Figure 2-2 does not really show much growth in consumer credit relative to income very recently, there is, of course, no reason this ratio of consumer credit relative to income should not continue to rise slowly. As income rises and necessities become a smaller proportion of income for many families, the goods and services like autos, home modernization, and higher education that stimulate credit use can become a larger segment of overall budgets. This change undoubtedly has been true for many families, contributing to the slow rise in this ratio (witness, for example, the increase in multiple-car families since the 1950s, along with more appliances and recreational durable goods and more higher education). Increases in two-earner families over time also suggest the availability of more income to devote to the kinds of goods and services often purchased using credit. The important message here is that this ratio has risen over time since the end of World War II, but it does not indicate some dramatic increase recently, despite what sometimes seems like widespread belief to the contrary.

Significantly, lengthening maturities of consumer credit contracts also increase the amount of credit outstanding as repayments slow, but they have the opposite effect on the actual burden on users by reducing amount of current repayments relative to income. Beginning in 1980, the Federal Reserve has provided a statistical series of consumer-credit repayments compared with



household income, the actual burden of debt on household finances (see Figure 2-3).<sup>15</sup> This series shows no trend over the years 1980-2019 and was actually lower at the end of 2019 than in 1980.

**FIGURE 2-3:** CONSUMER CREDIT (CC) DEBT SERVICE RATIO (DSR) MEASURED AS %



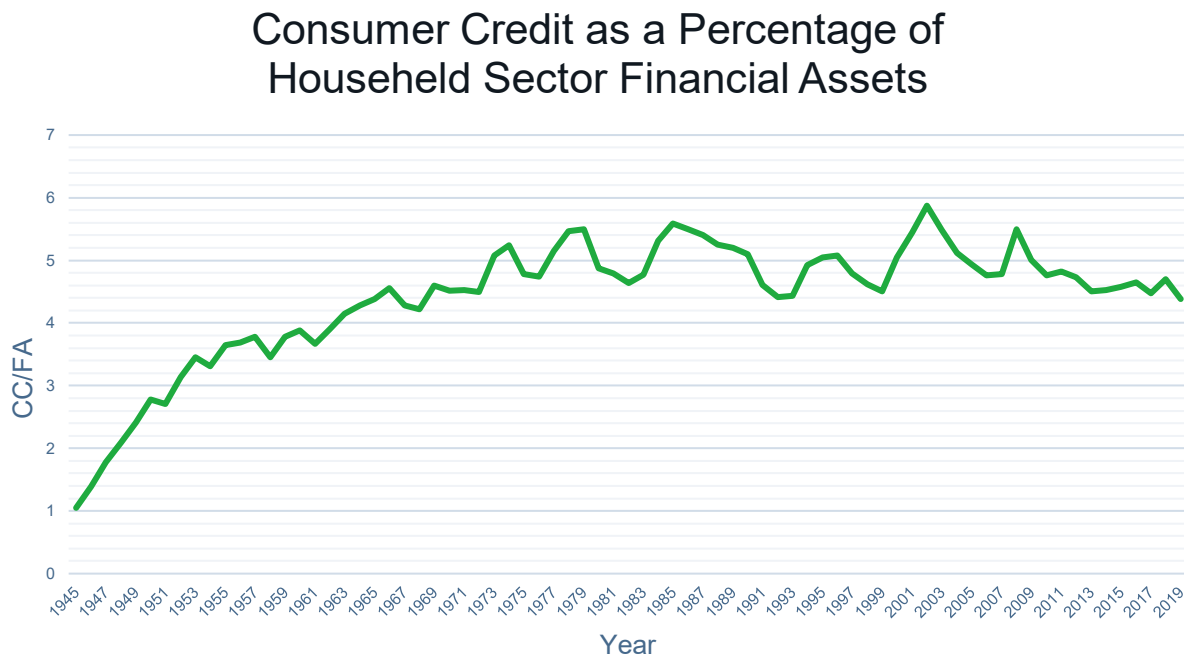
Assets, and particularly liquid assets, represent other means of repayment. There has been considerable concern in recent years that a portion of the population remains very illiquid and often unable to deal easily with financial emergencies that might arise.<sup>16</sup> This could make them candidates for small amounts of necessitous credit, sometimes argued as abusive kinds of credit. But, as described in Chapter 4, the bulk of the population holds substantial amounts of financial assets of various kinds that also are part of the household-sector financial structure and can serve as needed as means of credit repayments.

<sup>15</sup>The Federal Reserve calls this the Household Debt Service Ratio or DSR, released quarterly in an unnumbered statistical release.

<sup>16</sup>For instance, see BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT ON THE WELL-BEING OF US HOUSEHOLDS IN 2018 (Washington: Board of Governors of the Federal Reserve System, 2019) and similar reports annually in the previous five years.

Figure 2-4 shows overall consumer credit outstanding relative to household sector financial assets measured by the Federal Reserve’s Financial Accounts of the United States series (formerly known as the Flow-of-Funds accounting system, see Federal Reserve quarterly Statistical Release Z1). Financial assets include liquid assets like deposits and close substitutes, plus bonds, stocks, and mutual fund shares.

**FIGURE 2-4: CONSUMER CREDIT AS A PERCENTAGE OF HOUSEHOLD SECTOR FINANCIAL ASSETS**



The chart shows that aggregate consumer credit has remained consistently at 4 percent to 5 percent of aggregate household-sector financial assets since the 1950s. Consumer credit outstanding has remained consistently about one-fifth to one-quarter of household-sector liquid assets (deposits and close substitutes) since the early 1960s (not shown in the figure). Most recently (2019), this measure is about at the middle of its range over this time, at 22 percent.

## 2.4 Distribution of Consumer Credit within the Population

Of course, statistics of aggregate amounts of consumer credit outstanding gathered from lenders and reported in these charts do not say anything about the distribution of the credit among the population, which is only available from surveys of consumers. To meet this need, the Survey Research Center of the University of Michigan began its Surveys of Consumer Finances in 1946,

sponsored over the decades mostly by the Federal Reserve. The surveys were annual until 1970, periodic until 1989, and more recently have settled into a three-year frequency (as indicated earlier, since 1992 the National Opinion Research Center of the University of Chicago has taken over the data collection). After each survey, the Federal Reserve staff undertakes substantial efforts to prepare the dataset involving data editing, studying and eliminating discrepancies, estimating missing information statistically, and producing the final dataset for analytical use. The agency staff then makes it publicly available electronically. All this means that the final dataset is not available for analysis for a year or more after the survey, unlike the lender surveys that produce the familiar monthly statistical reports by provider groups widely reported in the financial press.

The Surveys of Consumer Finances show that credit use is widespread through the domestic population. The surveys also show that the portion of users has grown over time. Evidence over seven decades of the surveys demonstrates how the slow long-term rise in the debt-to-income ratio noted earlier is associated with greater inclusion within the credit system. As income and wealth have increased over time, and as lenders have grown in experience with credit granting (and creditors have employed new technologies for credit evaluation), the portion of the public using credit has increased. Since passage in 1974 and amendment in 1976, the Equal Credit Opportunity Act has made illegal any creditor unwillingness to deny inclusion on a list of prohibited bases.

Most observers agree that greater credit access and inclusion within the system is a good thing. Credit access provides many benefits to individuals (discussed further in Chapter 3), which leads to demand for credit. Evidence of widespread inclusion shows that credit supply to them is extensive as well. It is important to note that benefits of credit use, and therefore advantages of inclusion, extend even to younger and lower-income consumers and to older borrowers. It follows that if many individuals benefit from access and inclusion, then so does society as a whole.

It also appears that there has been greater cultural acceptance of credit use over time. No longer is credit use for household purposes as generally frowned upon as in the Victorian period. Some still argue against using consumer credit, but this view is much less widespread than in the past. There also still are issues of blame that arise when some individuals take on too much debt relative to ability to repay comfortably or if something in their lives goes wrong (like unemployment) after taking on the debt. Nonetheless, consumer credit use today also is generally regarded as culturally acceptable and recognized as useful, and sometimes even critical, much more than in the past. More significantly, today its importance for wealth building

is also much better understood. As indicated, underlying reasons for credit use are discussed further in the following chapter.<sup>17</sup>

The surveys illustrate that growing inclusion within the system (sometimes also referred to as “debt widening”) actually is not new in recent decades; much of it took place in the years immediately after World War II until about 1963 (see Table 2-2). Comparison of survey results show that, in 1951, about 32 percent of American households (including single-person households) were using consumer installment credit, a credit definition that included in those days only nonrevolving consumer credit and not revolving consumer credit that came later (first line of Table 2-2). This was up from a very low, but unrecorded, proportion in 1945, reflecting wartime restrictions on both production and financing. The proportion of households using closed-end consumer installment credit rose to about 50 percent by 1963 and has remained within the range of 41-50 percent since then (first line of Table 2-2).<sup>18</sup>

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<sup>17</sup>For discussion of changing cultural acceptance of consumer credit over time *see* LENDOL C. CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT*, *op. cit.*

<sup>18</sup>Rather than using any data tables from other sources, the tables here using data from the Surveys of Consumer Finances were recalculated from the original source data by Durkin, Elliehausen, Staten, and Zywicki and updated to 2019 by the Taskforce in order to ensure, as far as possible, comparability of conception and definition of variables over time. For this reason, the data tables here may show some small differences from otherwise apparently comparable tables in other analyses using the same survey data. For example, the tables here always define credit for mobile homes as consumer credit and not mortgage credit (since mobile homes are not real property and credit to purchase them is consumer credit in the Federal Reserve Board’s statistical series). But such credit may not always be considered consumer credit instead of mortgage credit by other analysts (since it is housing related) and other analysts may prefer to keep mobile home credit with the rest of housing-related debt. There also may be other slight definitional differences between these and tables in other sources, although all such statistical differences are small. The definitions of consumer credit employed here follow Federal Reserve usage, as noted in Chapter 1.

**TABLE 2-2: PROPORTIONS OF HOUSEHOLDS USING CREDIT, 1951-2019, IN PERCENT**

Type of Credit	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
Closed-end Installment Credit	32	45	50	49	49	41	44	45	44	41	47	50	49
Credit Card With Revolving Balance <sup>a</sup>				22	34	37	40	47	44	46	39	44	55
Notes: Have Any Credit Card <sup>b</sup>				51	63	65	70	74	76	73	68	71	79
Have Bank-type Credit Card				16	38	43	56	66	73	70	64	71	75
Any Consumer Credit <sup>b</sup>	46	53	59	54	61	61	62	64	63	66	62	66	67
Mortgage Credit <sup>c</sup>	20	24	32	35	40	39	38	39	42	46	41	40	40
Consumer Credit or Mortgage Credit	53	62	67	64	70	69	70	72	73	75	73	75	75

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

<sup>a</sup>Cardholders with a balance remaining after the most recent payment. In 1995-2001, includes a few respondents with open-end retail revolving credit accounts not necessarily evidenced by a plastic credit card.

<sup>b</sup>Closed-end installment credit, open-end installment credit (including credit card accounts and unsecured lines of credit), and noninstallment credit (excluding credit for business or investment purposes).

<sup>c</sup>Includes home equity credit and home equity lines of credit with a balance outstanding.

Beginning in 1970, survey changes made it possible to provide more detail on use of credit cards. Most credit cards in 1970 were issued by retail stores and gasoline companies for use only at their own outlets. Many of these issuers originally provided only charge cards where payment of the bill in full was due shortly after receipt, and the amounts of credit outstanding were counted within noninstallment credit at the time. But attaching a revolving credit feature to these cards was rapidly becoming more popular by 1970.

Even more important for consumer credit markets in the long run, three-party cards such as MasterCard and Visa (then known as Master Charge and BankAmericard) began to become widely available from banks in the late 1960s and eventually could be used almost anywhere. Originally issued only by commercial banking organizations, these cards are sometimes still called bank-type credit cards, although other financial institutions including savings institutions, credit unions, and others now also issue them. (The first three-party card – consumer, merchant, and financial institution – was the Diners Club Card in the early 1950s. For many years, it remained a charge card, although it eventually added a revolving-credit feature.)

Bank-type cards were in the pockets and purses of only 16 percent of households in 1970. The proportion grew to 73 percent in 2001 before falling off slightly afterward (including 64 percent measured in 2013 after the sharp recession earlier in the decade (second line of Table 2-2)). As indicated earlier, over these decades credit cards have taken over much of the work of routine extension of consumer credit for many household purposes, in addition to their role in substituting for cash and checks in many instances. Much of previous consumer credit for

appliances and home repairs that in past decades would have involved the credit department of the retailer and sale of the credit contract to a finance company is now handled much more conveniently through the prearranged credit line of a revolving credit card account. Thus, much of the growth in credit-card credit since the 1960s is really a substitution due to technological change rather than a whole new area of credit use.<sup>19</sup>

Including households who have remaining revolving balances on credit card accounts after making their monthly payment (line 2) within the definition of consumer-credit users raises the total proportion of consumer credit-using households. The proportion increased from 46 percent in 1951 and 53 percent in 1956 in the early postwar period, when consumer credit use grew most rapidly to around 60 percent in the half-century 1963-2013 (fifth line of Table 2-2). Consumer-credit users reached about two-thirds (66 percent) in the 2007 and 2016 measurements.

## 2.4.1 Consumer Credit Use According to Income and Age

Considering inclusion further, the surveys also permit examination of trends in debt use within population segments. Sometimes the view is heard that that consumer credit use is a low-income or lower-middle-income phenomenon, particularly among younger consumers. Actually, the surveys show that low-income, middle-income, and younger consumers have always been users of consumer credit, but that credit use over time has also expanded in all income and age groups.

To look at the use of consumer credit by income level, household respondents to each of the Surveys of Consumer Finances illustrated in Table 2-2 were arrayed according to income and then placed into one of five groups of equal size (quintiles) from lowest to highest income (see Table 2-3). Looking at income quintiles this way frees the discussion from the issue how the definition of “low income” or “high income” might change over time due either to inflation or economic growth. In each year, the lowest income quintile, for example, includes the fifth of the surveyed population with the lowest incomes and the other income quintiles consist of the respective other fifths of the income distribution.

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<sup>19</sup>A research paper by Elliehausen and Hannon showed that this substitution can also go the other way when new constraints arise in the extension of credit on card accounts. Following the sharp recession of 2008-9 and implementation of new Federal restrictions on credit-card management and pricing around the same time, card holding in the lowest-income quintile declined and finance company lending increased. See Gregory Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, *Journal of Financial Intermediation*, 34, 109 (2016).

**TABLE 2-3: PROPORTIONS OF HOUSEHOLDS USING CONSUMER RELATED CREDIT BY INCOME GROUP, 1951-2019, IN PERCENT**

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
<b>Consumer Credit*</b>													
Income quintile													
Lowest	24	37	45	26	38	38	43	44	44	45	45	51	47
Second lowest	41	57	58	49	57	53	52	60	62	59	59	63	66
Middle	56	59	67	65	68	69	69	70	71	76	71	73	75
Second highest	55	61	69	70	73	75	78	78	73	80	72	76	79
Highest	52	52	59	57	71	72	68	70	62	68	65	66	66
All	46	53	59	54	61	61	62	64	63	66	62	66	67
<b>Any Credit (Consumer Credit or Mortgage Credit)</b>													
Income quintile													
Lowest	29	40	46	30	44	42	45	47	47	50	50	56	51
Second lowest	46	61	64	56	62	58	58	66	68	66	65	68	72
Middle	63	67	74	75	76	76	76	77	81	83	79	82	81
Second highest	64	70	78	81	84	84	85	86	84	90	86	87	88
Highest	63	71	75	79	85	87	86	86	86	87	84	83	85
All	53	62	67	64	70	69	70	72	73	75	73	75	75

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

\*Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or financial investment purposes).

Table 2-3 shows the proportion of each income quintile with some kind of consumer credit outstanding at the time of the survey. (This includes closed or open-end installment credit in later years and non-installment credit in earlier times) for each of the survey years illustrated in the previous table. The following table (Table 2-4) then measures the proportion of households with these kinds of credit outstanding among population age groups arrayed from the youngest respondents to the oldest.

**TABLE 2-4: PROPORTIONS OF HOUSEHOLDS USING CONSUMER-RELATED CREDIT BY AGE GROUP OF FAMILY HEAD, 1951-2019, IN PERCENT**

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
<b>Consumer Credit<sup>a</sup></b>													
Age group													
Under 35	54	71	76	70	77	74	74	78	76	76	72	76	74
35-44	61	60	72	67	78	78	78	78	74	72	73	77	76
45-54	45	54	62	60	69	70	71	72	68	72	68	74	76
55-64	34	42	45	42	54	55	53	59	58	66	62	61	66
65-74 <sup>b</sup>	16	19	26	16	26	29	38	41	42	51	50	57	56
75 and over				9	13	13	17	22	23	23	31	36	40
All	46	53	59	54	61	61	62	64	63	66	62	66	67
<b>Any Credit (Consumer Credit or Mortgage Credit)</b>													
Age group													
Under 35	59	76	81	76	82	79	78	82	81	82	76	80	78
35-44	69	74	82	83	90	87	88	85	87	85	84	86	86
45-54	54	63	72	74	82	81	83	83	83	85	82	84	84
55-64	42	52	53	51	65	66	65	73	73	80	75	75	76
65-74 <sup>b</sup>	23	25	33	27	34	36	47	51	54	63	64	68	68
75 and over				14	13	17	20	26	28	30	35	47	50
All	53	62	67	64	70	69	70	72	73	75	73	75	75

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

<sup>a</sup>Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or investment purposes).

<sup>b</sup>In 1951, 1956, and 1963, 65 and over.

These tables show growing inclusion in all income and age segments 1951-2016. Among income groups, the greatest relative growth in frequency of credit use occurred in the lowest income quintiles 1951-1963; since then, growth in the credit-using population has been moderate in all income groups (upper panel of Table 2-3).<sup>20</sup> Each of the three highest income groupings registered half or more of their members as consumer-credit users in as long ago as 1951 (lines 3-5 of the upper panel of Table 2-3), and the proportion in the third and fourth quintiles reached two-thirds by 1963 (lines 3-4). By 2016, half or more of all income groups were included in credit users and the proportion reached about three-quarters in the third and fourth income quintiles.

Looking at age groups, over the decades the Surveys of Consumer Finances have indicated consumer-credit use shows a life-cycle effect. The NCCF noted this in 1972 (P. 12):

The frequency of installment credit use in relation to age of the family head is, of course, intimately related to the level of income and stage in the life cycle characteristic of that age.

<sup>20</sup>There is a drop in credit use recorded by the 1970 survey among the lowest income segments. This may reflect that 1970 was the only recession year among the survey years in the table. The 2010 survey followed the end of a sharp recession by about six months, and it also shows a general drop in credit use although not in the lowest income quintile (not in table, see DURKIN, ELLIEHAUSEN, STATEN, AND ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY, op. cit., p. 72).



Those in the younger age groups ... used installment credit most frequently. A significant decline in the frequency of use did not occur until after age 55.

The profile that emerges is that the consumer most likely to acquire goods and services is young, married, with children at home, and with family income between \$7,500 and \$15,000 [Note: These were middle-class amounts in 1972.] The stage in life cycle of the family appears to be the most influential in determining frequency of use, while the level of income probably has the greatest influence on the quantity of debt and the quality of the goods and services acquired.

Within age groups, consumer credit use has always been most prevalent among younger consumers. It has long been understood that use of credit is strongly influenced by stage of life cycle, and in the next chapter we will discuss this further. Households headed by younger individuals, for example, are more likely below their long-term average lifetime income level. They also are bearing the costs of acquiring housing and household durable goods, rearing and educating children, etc., and so they are willing to use credit knowing their ability to repay debts that finance these activities likely will rise. Consequently, it is not especially surprising that more than three-fifths of households with heads younger than 45 were consumer credit users in the mid-1950s, and this proportion rose to three-quarters in 1977 and has remained around that level since then (lines 1-2 of the upper panel of Table 2-4).

In contrast, households near or past retirement may not have as many such needs, and they may have accumulated more liquid savings and not need to use credit as often. This life cycle effect is also visible in Table 2-4, although the greatest growth of credit use in percentage terms occurred among older consumers. The proportion of those using consumer credit in the 55-64 age bracket rose substantially over these years, to about three-fifths by 1995 (line 4 of the upper panel). Furthermore, only about one-fifth of households with heads over 65 were consumer-credit users in the mid-1950s, but this proportion has risen over time (lines 5-6). Thus, along with population growth, it seems that an aging population, combined with a higher proportion of older consumers who still use consumer credit, accounts for at least some of the increase in consumer credit outstanding in recent decades. Extremely low interest rates on such things as new car loans in recent years probably had something to do with this trend. For creditworthy older consumers, why use reserves or assets that can be made tax-deferred through IRAs rather than inexpensive credit? Growth of consumer credit use among older consumers is an area for further research.

## 2.4.2 Shares of Credit Outstanding

Cross-section surveys also permit calculation of the share of total debt held by various groups of consumers. The next two tables contain calculated shares of selected kinds of debt outstanding

owed by consumers segmented first by income (Table 2-5) and then by age (Table 2-6). Results of this effort turn out to be revealing and maybe a bit surprising.

**TABLE 2-5: SHARES OF KINDS OF CONSUMER-RELATED DEBT OUTSTANDING BY INCOME GROUPS, 1951-2019, IN PERCENT**

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
<b>Closed-end Consumer Installment Credit</b>													
Income quintile													
Lowest	7	6	6	3	5	4	4	7	8	8	10	9	8
Second lowest	14	12	15	16	13	12	9	13	15	12	13	13	14
Middle	22	23	25	24	23	19	22	22	21	22	18	20	22
Second highest	27	30	26	31	27	27	34	28	28	30	26	28	29
Highest	31	29	27	27	31	37	31	30	29	29	32	30	27
All	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>Revolving Balances on Any Credit Card</b>													
Income quintile													
Lowest				2	4	4	2	7	7	6	5	6	8
Second lowest				10	12	10	9	15	13	9	12	13	16
Middle				24	19	20	21	20	22	18	21	17	18
Second highest				35	35	30	30	24	26	32	27	28	29
Highest				30	31	36	38	34	32	34	34	35	29
All				100	100	100	100	100	100	100	100	100	100
<b>Consumer Credit<sup>a</sup></b>													
Income quintile													
Lowest	6	10	8	3	5	7	5	7	8	9	10	9	8
Second lowest	14	14	14	15	13	12	10	13	15	11	14	14	14
Middle	23	22	25	24	22	18	22	21	21	20	19	19	21
Second highest	27	25	25	31	28	25	32	27	27	30	26	28	28
Highest	31	29	28	27	32	38	31	31	29	29	32	30	28
All	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>Mortgage Credit</b>													
Income quintile													
Lowest	3	2	2	2	3	3	1	2	2	3	3	3	3
Second lowest	8	5	7	7	7	6	5	7	5	5	6	6	6
Middle	17	16	15	17	17	12	12	12	14	15	12	12	12
Second highest	28	26	31	31	28	25	26	26	24	26	24	24	24
Highest	44	51	45	43	44	54	56	53	54	51	55	55	55
All	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>Any Credit (Consumer or Mortgage)</b>													
Income quintile													
Lowest	4	4	3	2	4	4	2	3	3	4	4	4	4
Second lowest	9	7	8	8	8	7	6	8	7	6	8	8	8
Middle	18	17	17	18	18	13	14	14	15	15	13	14	14
Second highest	28	26	30	31	28	25	27	26	25	27	24	25	25
Highest	42	46	42	40	42	51	51	49	50	48	51	49	49
All	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

<sup>a</sup>Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or investment purposes).

Columns may not add to totals because of rounding.

**TABLE 2-6: SHARES OF KINDS OF CONSUMER-RELATED DEBT OUTSTANDING BY AGE GROUPS OF FAMILY HEAD, 1951-2019, IN PERCENT**

**Table 2-6. Shares of Kinds of Consumer-Related Debt Outstanding by Age Groups of Family Head, 1951-2019, in Percent**

	1951	1956	1963	1970	1977	1983	1989	1995	2001	2007	2013	2016	2019
<b>Closed-end Consumer Installment Credit</b>													
Age group													
Under 35	33	42	38	46	41	37	31	35	32	35	32	30	30
35-44	33	31	28	21	23	27	31	28	32	22	25	25	25
45-54	21	18	22	22	20	21	22	24	21	23	20	21	21
55-64	9	8	9	10	13	12	10	8	10	14	15	15	14
65-74 <sup>a</sup>	4	2	5	1	2	3	4	3	3	4	5	6	7
75 and over				0	1	0	1	1	1	1	2	3	3
All	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>Revolving Balances on Any Credit Card</b>													
Age group													
Under 35				44	35	29	32	27	25	16	12	14	13
35-44				25	23	30	29	29	28	23	20	19	18
45-54				21	27	20	21	26	24	27	23	27	24
55-64				9	11	16	11	11	12	22	25	21	21
65-74 <sup>a</sup>				1	3	4	6	5	9	10	13	13	16
75 and over				0	0	1	1	1	2	2	7	6	9
All				100	100	100	100	100	100	100	100	100	100
<b>Consumer Credit<sup>b</sup></b>													
Age group													
Under 35	34	36	37	45	40	35	32	33	30	30	29	28	27
35-44	32	28	27	21	24	26	31	28	31	22	24	24	25
45-54	21	20	22	22	20	20	21	25	22	24	21	22	21
55-64	10	10	9	10	12	14	10	9	11	17	17	15	15
65-74 <sup>a</sup>	3	5	5	1	2	3	4	4	5	6	7	7	8
75 and over				0	1	1	2	1	1	1	3	3	4
All	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>Mortgage Credit</b>													
Age group													
Under 35	30	31	27	29	38	29	29	20	18	19	13	12	14
35-44	33	39	36	36	30	34	38	34	32	27	26	25	27
45-54	23	18	25	24	20	20	19	29	30	28	27	28	25
55-64	10	8	8	7	9	12	11	12	13	18	21	21	19
65-74 <sup>a</sup>	3	3	3	3	2	3	3	4	6	7	10	10	10
75 and over				0	0	0	1	1	1	1	3	4	4
All	100	100	100	100	100	100	100	100	100	100	100	100	100
<b>Any Credit (Consumer or Mortgage)</b>													
Age group													
Under 35	31	33	29	32	38	30	30	23	20	21	16	16	17
35-44	33	37	35	34	29	33	36	33	32	26	26	25	26
45-54	23	19	25	23	20	20	19	28	29	27	26	26	24
55-64	10	8	8	8	10	13	11	12	12	18	20	20	18
65-74 <sup>a</sup>	3	4	3	3	2	3	3	4	6	7	10	9	18
75 and over				0	0	0	1	1	1	1	3	4	4
All	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Data from the Surveys of Consumer Finances. Columns may not add exactly to totals because of rounding.

<sup>a</sup>In 1956 and 1963, 65 and over.

<sup>b</sup>Closed-end installment credit, open-end installment credit (including credit card accounts), and noninstallment credit (excluding credit for business or investment purposes).

The central message from the distribution of debt shares measured by the cross-section surveys is stability over time rather than dramatic change; there have been inclusion and outstanding consumer and other credit increases in all income and age groups, leaving the shares quite similar over time. Focusing on consumer credit, the third panel of Table 2-5, shows that the

upper two income quintiles owed 58 percent of consumer credit outstanding in 1951, exactly the same proportion as in 2016. It must be kept in mind, of course, that some of this pattern is produced by keeping the sizes of the income groups the same (quintiles). If the group sizes were allowed to change over time to, say, groups representing “low income” versus “middle class” or “comfortable,” the amount of debt owed by the latter would undoubtedly rise as the group becomes larger due to increasing income and wealth among the population as a whole over time.

By age, where the size of the groupings is not static, the story is a bit different. Younger families have always been large users of credit, but there has been a gradual shift of the share owed toward older users over the decades. Households classified as headed by individuals under age 45 have been and remain the largest users of consumer credit, but these households have lost share since 1951 (lines 1-2 of the third panel of Table 2-5). Households with heads over age 45 have increased their shares of installment credit owed, presumably in part because the population has aged and more individuals are in the upper age groups now. Some of them may also consider debt less expensive and more acceptable now than their counterparts did years ago. As the share of older consumers has increased, the share of others necessarily has decreased.

Balances owed specifically on credit cards definitely show an aging effect (second panel of Table 2-1). In 1970, when credit cards with a revolving credit feature were relatively new, the youngest households owed 44 percent of the card debt (line 1). This probably represents the ages-old phenomenon in which the young are more willing to try new things. By 2016, when the older cohort surveyed that year had literally grown up using credit cards, the share of card debt owed by households in the youngest age grouping had fallen by about two-thirds to 14 percent. This decline may also result from some difficulties that younger consumers may have in acquiring credit cards in recent years. The bulk of the offsetting increases in share were among households with heads over the age of 55.

### 3. Demand for consumer credit

Previous chapters showed that credit use by individuals is as old as recorded history, and its regulation is just as old, but credit today labeled “consumer credit” became widespread domestically only in the 20th century and especially after World War II. The National Commission on Consumer Finance (NCCF) undertook its review of consumer credit conditions 50 years after modernization of consumer credit began in the 1920s, and full maturation had taken place in the early postwar era. At the outset of the 1970s, the NCCF produced a list of recommendations for updating existing credit processes and regulations to help consumers, the relevant institutions, and the legal environment work better together.

The NCCF did not spend a great deal of time in its 1972 *Report* discussing underlying individual economic motivations for consumer credit use, known in economics as credit demand. Apparently, the NCCF believed that by this time the reasons were fairly obvious. The NCCF found that some credit use was by “necessitous” borrowers down on their luck (and often without much discretionary income—i.e., often poor), but most modern consumer credit use was much more mainstream. The NCCF’s *Report* reflected the economic theory of consumer credit that had developed during the credit-modernization period, and it recorded the empirical evidence.

Serious economic study of consumer credit began a century ago, around the time of the beginnings of the “modern period” of credit use in the 1920s. To preview the discussion in the current chapter, at that time economists determined that consumer credit was more than a means of merely advancing the pleasures of household consumption; rather, it supported household capital formation.

There are two major benefits from encouraging capital formation through credit use: First, credit use facilitates purchase of goods and services such as housing, vehicles, appliances, home repairs, and education that provide a return over time from their services; second, credit use enables consumers to adjust consumption patterns over time including over their entire life cycle to a preferred pattern. Credit use enables purchases like housing and durable goods and services at younger ages when they provide high rates of return for those who have not yet acquired such assets. Necessary saving can take place through repayments when incomes have risen. This provides a clear life-cycle effect in credit use where it is most frequently used by the young and use fades a bit with aging. To economists, this is known as a life-cycle effect.

Empirical evidence shows that most consumer credit use arises with household spending to acquire capital goods that provide benefits over time: acquisition of consumer durable goods and services like transportation assets (vehicles), appliances and furniture, home repairs and modernization, substantial hobby and recreation items, higher education, and mitigation of emergencies. Purchases of this kind involve more than merely current consumption. Instead, they are precisely the kinds of purchases that provide ongoing household services producing additional future benefits, not merely shifting consumption from the future to the present as commonly believed in the past. Consumer investments provide a return in preferred consumption over time that can easily exceed the cost of the credit used in acquisition—investments that provide a positive return amount to household capital. They are analogous to industrial capital assets, and are wealth and welfare enhancing.

There is a visible life-cycle effect in the purchase of such assets and the accompanying use of consumer credit: Credit use is more frequent among younger consumers, as discussed in Chapter 2. This is the time in the life cycle when asset holdings and household capital typically are low and the rate of return upon acquiring them is high. It also is the time when ready credit availability likely is lowest due to family incomes that have not yet grown, and families have not yet demonstrated to potential lenders the ability to manage credit use successfully. High return and low credit availability in such situations explain why credit demand can exceed supply from mainstream suppliers and how some households at certain times are willing to use higher-cost alternative credit products, even such forms as payday loans discussed further in Chapter 5.

As households mature, they typically reduce debt use gradually and often transition from borrowing to lending, investing funds by lending to banks and other financial intermediaries such as insurance companies and pension providers (including IRA trustees) through various savings products. These institutions then lend the funds to businesses, governments, and other consumers. The process of lending to institutions to lend to others is conventionally called “saving,” but it should be recognized that it is simply another way in which households make investments that generate a positive return. In this case, the return is through interest payments, life insurance protections, pensions, and other benefits of savings products received from the institutions.

Empirical studies over many decades have confirmed this simple but powerful neoclassical economic model that the primary use of consumer credit by most families is to make productive investments rationally that generate a positive return over time. In this sense, most consumer credit usage is similar to the reasons businesses use credit. This chapter reviews the neoclassical model of consumer demand and the empirical evidence that has validated it over time. The chapter then discusses behavioral economics approaches to demand for consumer financial services and especially consumer credit, a novel theory that questions the neoclassical consensus that has dominated the field since its inception a century ago.

## 3.1 Reasons for Credit Use

The NCCF was aware of the economic theory and evidence that had developed, which was by no means new even in its time. Concerning reasons for credit use, the NCCF stated in its *Report* (page 5): “The reasons for this increased use of consumer credit may be found in the natural adaptation of consumer and business changes to changes in the ability and willingness of consumers to incur debt, as well as to a continued shift toward the ownership of assets.” In the next few paragraphs, the NCCF mentioned a number of factors. They included increasing and more stable household incomes in the postwar period, increased urbanization of the population, changing population age distribution toward younger families, more women in the workplace necessitating changes at home, and enhanced willingness of creditors to lend. The NCCF also discussed trends in the sale of household durable goods and then closed this section by returning to the importance of increased asset ownership (page 6):

The shift to asset ownership also reflects a decision by consumers to substitute the use of consumer-owned capital goods for the use of commercially owned capital goods. Thus, the purchase of an automobile substituted, perhaps unfortunately, for daily fares on street cars and buses, the home washing machine and dryer for payments at the laundromat, and the television set for the admission price to movies and other forms of entertainment. Even if the auto or appliance were purchased on credit, the monthly installments paid for it over a much shorter interval than the period of time over which services were received. In addition, quite often consumers also gained significant returns on their investment.

These motivations are intuitive as well as consistent with economic theory and empirical evidence. By itself, however, acquisition of investment assets (or satisfying necessitous situations) is not the complete answer to the question of underlying economic motivation leading to consumer-credit use. There actually is more to the story. As indicated, economists have thought about the essentials of this motivation for more than a century.<sup>1</sup>

For descriptive purposes, it is common to say that consumers use consumer credit for such and such a purpose, most notably for purchase of costly assets. Nonetheless, a little reflection quickly

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<sup>1</sup> For the early development of theory in this area, see IRVING FISHER, *THE RATE OF INTEREST: ITS NATURE, DETERMINATION, AND RELATION TO ECONOMIC PHENOMENA* (1907); see also IRVING FISHER, *THE RATE OF INTEREST* (1930), and EDWIN R. A. SELIGMAN, *THE ECONOMICS OF INSTALLMENT SELLING: A STUDY IN CONSUMERS' CREDIT* (1927, two volumes). The foundational economics is discussed in considerably more detail than here in THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, and TODD J. ZYWICKI, *CONSUMER CREDIT AND THE AMERICAN ECONOMY* (2014); and GREGORY ELLIEHAUSEN, *Behavioral Economics, Financial Literacy, and Consumers' Financial Decisions*, in ALLEN E. BERGER, PHILIP MOLYNEAUX and JOHN O.S. WILSON, *THE OXFORD HANDBOOK OF BANKING* (2019). For discussion of cultural aspects of development of consumer credit in the twentieth century and its institutions, see LENDOL C. CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* (1999).

shows that buying autos, household repairs and furnishings, major hobby items, and education is only part of the fundamental economic behavior that gives rise to these classifications of debt. There is another part.

Rather, it is useful to recall that a significant component of the underlying, basic economic demand motivation for consumer credit use is the desire by consumers to change both the size pattern and the timing of their resource inflows and outflows, especially the investment outflows. Credit markets arise to change the lumpiness of the patterns, particularly of the outflows for purchasing housing and durable goods or for necessities, and to bring *household capital investment* transactions forward in time to the present instead of far off in the future.

In more detail, most purchases on credit could be accomplished by accumulating cash first and then buying the item later, but this often is not the time pattern consumers prefer. Significantly, for many goods, accumulating cash first could mean doing without the item or paying for more expensive substitute services for a period that might amount to years, both of which are costly. For instance, delaying purchase of a vehicle while saving enough cash to make a cash purchase means doing without the convenience of available transportation, possibly limiting places to live, and paying for expensive transportation substitutes meanwhile. Not managing some emergency situation could prove even more costly. Waiting to make these asset adjustments is frequently not going to be the preferred option in societies where there is an alternative. The types of credit we observe in the marketplace in large part come about because they are the least costly ways of providing an acceptable alternative.

Specifically, inflows from salaries and wages that comprise the income of most employed workers in a modern economy typically are quite regular for most consumers (even for many hourly workers), and credit offers the opportunity to smooth the outflows. Lumpiness in outflows can occur during the course of the period between paychecks, but it certainly will occur during the course of longer periods like a year, within a particular life-cycle stage, or over a consumer's or family economic unit's whole lifetime.

For example, for many families, expenditures increase during selected seasons like vacation periods, back-to-school time in September, and around the year-end holidays. Then in some years, there also are bigger, investment-type purchases, such as an automobile or a new home. A few years later, there may be need for another auto or a larger home, and later still for college education for children. Purchase of a vacation home or a large recreation item like a boat may take place once or twice in a lifetime. Home repair or modernization may be important at some points. Sometimes there also are emergencies.

Credit facilitates all these transactions by enabling households to use future regular inflows for the saving necessary to pay for lumpy expenditures made today. Consumers have shown that they are willing to pay a price in the form of interest and finance charges for the possibility of



changing the time pattern of saving to a preferred one: acquiring the relevant asset and the return advantages it provides now, thereby obviating the need for costly substitutes while undertaking the saving.

This picture of inflow and outflow/expenditure patterns illustrates how it often is not really correct to say that credit arises solely for the purpose of purchasing specific investment items. The purchases could often be made anyway, just on a different schedule. The accumulating (saving) could be done first, although this would also mean postponing the benefits of the investments (or not solving the emergency situation) and paying for substitutes meanwhile, often for a long time, both of which are costly. The correct interpretation is that credit markets arise to increase consumers' overall well-being by changing the time pattern of both saving and expenditure outflows (typically for lumpy, large purchases) to a preferred one.

The classification by usage problem is especially obvious in the example of an individual purchasing a \$35,000 automobile or truck on credit but who simultaneously holds \$35,000 or more in a savings account, IRA, 529 college savings plan, or some other financial asset. In some significant sense, this individual is not really using credit only to purchase the vehicle. Rather, the underlying motivation for credit use is to avoid some combination of not buying the car or truck now and entailing costs in not being able to undertake transportation, not giving up some other important purchases either, not paying taxes and penalties for liquidating assets held in retirement accounts, and not reducing reserves stored in other financial assets. Risk-averse consumers may well prefer not to reduce their reserves, which are valuable to them, and replacing them is costly. For many individuals, credit availability through good credit standing can also serve as at least a partial substitute for extensive advance and precautionary savings. In other words, credit availability obviates the need to do things consumers think are disadvantageous, like giving up substantial current consumption in order to make large purchases or periodically running down financial reserves, while still matching the pattern of outflows (payments) better to inflows (paychecks).

Certain kinds of credit associated with specific sorts of investment purchases arise because they permit changing the flow pattern in the least costly manner. Credit is often associated with automobile purchase transactions, for example, because the associated expenditure is large and because relatively large amounts of credit at relatively low cost are readily available to those who are willing to offer the auto or truck as collateral for the loan. Such loans are so common that "automobile credit" has become a large industry by itself. Credit generated in the process of making home improvements and buying automobiles, durable goods, and education, and a variety of other transactions including payment of taxes, debt consolidation, etc., are all well-known types of consumer credit. Advertising for each usage is common, and many financial institutions memorialize these distinctions by separate departments and personnel, even separate subsidiaries and companies.

Most official figures of the volumes of credit for many “uses” are no longer assembled by the government’s statistical mills, largely for the conceptual reasons mentioned and because of the practical difficulties with collecting necessary data from creditors to generate meaningful statistical aggregates according to consumers’ use of the credit.<sup>2</sup> The only practical way to produce an estimate of consumer credit purposes is to design statistically reliable surveys of consumers like the Surveys of Consumer Finances, ask respondents about their credit experiences, and then in some manner extrapolate from their experiences to the broader public using statistical weighting procedures (see Chapter 2 of this Taskforce report for further discussion of the Surveys of Consumer Finances and some findings about credit use).

## 3.2 Neoclassical Economic Theory of Consumer Credit Demand

Consistent with these ideas and as indicated above, neoclassical economics, sometimes referred to as “mainstream economics,” began formal exploration of consumer credit use in the early part of the 20th century. Neoclassical economics soon produced a body of testable hypotheses that have stood the test of time.

As with use and production of other goods and services, underpinnings of neoclassical economics arise from the central concepts of demand and supply. In neoclassical economics, demand for anything arises from its usefulness or “utility.” Supply, in turn, depends on production costs and the potential opportunities for gains over production costs (profits) among potential suppliers. Interaction of demand and supply in markets produces exchange at prices reflecting the utility and production-cost characteristics of the products exchanged. Prices tend toward equilibrium where demand equals supply. Competition can lower prices to the lowest level consistent with covering production costs and profitability just sufficient to bring capital into the industry.

Economists have examined these notions of demand, supply, prices, equilibrium, and competition for decades, even centuries for some products. In these explorations, few areas have a richer history than credit demand and supply. Analysis of credit and credit markets has become a major mainstream area of economics known today as “finance.” And so, this chapter

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<sup>2</sup> In the past, the Federal Reserve collected information on amounts of consumer credit by usage in its monthly survey of credit volume at granting institutions, but the Board discontinued the usage collection decades ago, except for automobile credit and student loans. Before that time, the monthly surveys asked lending institutions to report credit according to whether it was for automobiles, durable goods, home improvement, or other, but even classifying credit into a few broad categories became increasingly difficult with the advent of open-end credit like revolving credit cards where lending institutions knew little or nothing about specific uses of the accounts.

looks in further detail at the basic question of the motivations for using consumer credit in the first place, the concept of credit demand in mainstream financial economics.

The next chapter then discusses credit supply, but not before the second part of this chapter moves to some recent ideas about the range of motivations that might influence credit demand. This latter discussion arises from suggestions for possible enrichments to mainstream economics that have arisen from a branch of the field known as behavioral economics. Suggestions from behavioral economics concerning use of financial services and especially credit use have not always been demonstrated empirically, however, as discussed further in the next section.

Today, most close observers of consumer credit find that its demand arises from its usefulness. Much of it clearly serves useful purposes by allowing individuals to purchase and use capital goods and services while simultaneously undertaking the saving to pay for them through loan repayments. For many individuals, this allows a change in timing of capital purchases to a more favorable schedule. Importantly, it also avoids the necessity of purchasing expensive substitutes in the meantime while the saving is taking place. People could take often expensive urban and suburban mass transit to work for years, for instance, while also foregoing the mobility they prefer by saving first rather than using auto loans. Likewise, people could exercise the high-opportunity cost of years with a lesser-paying (and possibly less satisfying) job while saving for college instead of employing a student loan.

The modern formal economics of credit use essentially began with the classic works of Yale University economist Irving Fisher in the early 20th century (Fisher 1907, 1930). Subsequently extended to consumer credit by Seligman, Hirshleifer, and Juster and Shay, Fisher's work provides the basic framework of the neoclassical economic theory of consumer credit use.<sup>3</sup>

The basic idea of the mainstream theoretical explanation for credit demand derived ultimately from Fisher is that individuals have available to them opportunities that provide a desirable future return. Examples include consumer durable asset purchases that provide a return over a future period. Opportunities also include services, like investing in human capital development such as education, and cost-reducing actions that mitigate the effects of emergencies.

These opportunities permit individuals to invest current resources to provide a return over time while saving for the purchase through loan repayments. The optimal amount of investment is undertaken when the rate of return on the next investment (declining as the more promising

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<sup>3</sup> See FISHER, *supra* note 1; see also SELIGMAN, *supra* note 1; Jack Hirschleifer, *On the Optimal Investment Decision*, JOURNAL OF POLITICAL ECONOMY, August, 1958; and F. THOMAS JUSTER AND ROBERT P. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION (1964).

investments are undertaken earlier) just equals the available interest rate on the next investment (rising as lender risk increases).

Investments that provide a return over time use current resources, however, possibly large amounts of them. If individuals prefer more current consumption than allowed by the remaining resources still available from current income, consumer credit permits them to borrow resources to finance the assets and still maintain preferred levels of current and future consumption through employing future saving to make the repayments. In other words, as individuals undertake the investment process that requires current resources and interferes with current consumption, they can borrow against future income in a way that advances both goals: 1) facilitating household investment with its returns and 2) preferred pattern of consumption.

Development of this theory demonstrated that the optimal investment decision with borrowing opportunities available can involve greater levels of investment and higher returns than otherwise. It also permits a more highly valued intertemporal pattern of consumption than the optimal investment without borrowing opportunities. This important result for consumer credit (discussed first by Seligman in 1927) countered the widespread belief held in the late 19th and early 20th centuries, and still existing today in some quarters, that all or much of consumer credit use is merely profligacy, an attempt to live beyond one's means. (Sometimes the profligacy notion of consumer credit used to be called disparagingly by some economists and other observers the "home economics" theory of consumer credit that saving should always take place first.)

Of course, there are exceptions to this general rule that credit use is not necessarily profligate, as there are to almost any such general statement. It is easy enough to cite examples of individuals who borrow when they probably should not. Some bad outcomes are even predictable in advance when repayment commitments visibly become too large for a satisfactory outcome.

But other bad outcomes from credit use come about because of events that arise only subsequently to the credit decision and were not predictable at the outset. They include credit failures that arise from economic problems such as job loss or other emergencies that reduce or eliminate expected future income. This involves the concept of risk. To limit these situations, creditors themselves have an interest in preventing too much credit expansion: Losses can ensue when credit for any individual becomes too high (even any credit amount greater than zero for some potential borrowers). Creditors guard against such situations by requiring initial equity in assets (through down payments), raising the price of credit as risk increases (higher interest rates), and by limiting credit altogether at some point (credit rationing). They also typically diversify their credit granting by lending to many consumers, not all of whom are likely to have the same emergencies or job losses at the same time.

Most consumers may not fully think about or understand all the components of the credit demand process outlined, but the economic theory derived from Fisher and Seligman is consistent with empirical evidence. Evidence shows that much of consumer credit use comes about in the process of acquiring consumer assets that provide a return over time. Such credit generation includes automotive credit, student loans, durable goods and large recreational goods credit, and credit involving home repairs and modernization. All these involve larger purchases that provide a return over time with payment patterns that do not eliminate current consumption either.

Another component of credit generation involves mitigating emergencies. Reducing or solving an emergency situation amounts to an investment addressing some cost-causing event, for example an automobile repair need or a health emergency. Eliminating or mitigating the emergency situation without also drastically changing the pattern of current consumption can reduce costs of the emergency, again providing a net positive return over time due to the reduced costs. In the case of a health emergency, the cost reduction (return) versus not fixing the problem could be substantial. In any of these events, focusing only on the cost of the credit without looking at the return is incomplete.

Another empirical finding described in Chapter 2 and mentioned earlier in this chapter is that consumer credit use is more frequent among younger households, especially younger families with children, than among older consumers. Younger households have had less time, and older consumers a longer time, to undertake investments and acquire productive consumer assets including transportation and education. This suggests that the younger consumers will often find remaining investment opportunities with higher returns than older consumers, and younger consumers will often be more willing to borrow to change the pattern of future consumption than their older compatriots. This has led to a life-cycle formulation of the pattern of consumer credit use.

Analysts such as Hirshleifer and Juster and Shay followed in Fisher's and Seligman's footsteps by relaxing some of the theoretical contentions especially relevant to consumer credit in the earliest manifestations of neoclassical finance theory. Hirshleifer explored the situation where rates that consumers can borrow are higher than rates at which they can lend. This led to the conclusion that there are situations when consumers will borrow (rate of return is greater than their borrowing-cost rate), lend (rate of return is less than their lending rate), or do neither (rate of return is between their borrowing rate and lending rate). All these possibilities are observable among differently situated consumers, with the younger ones most likely willing to borrow. Hirshleifer also explored the implications of rising borrowing rates for consumers as they take on more debt. He concluded that rising rates would reduce the amounts of investments and borrowing as rates rise, but this was consistent with the theory.

Even armchair empiricism suggests the reasonableness of Hirshleifer's conclusions. Many individuals will borrow when presented by attractive opportunities (returns are high), but they are less likely to continue borrowing at higher debt levels because interest rates rise and the protection of current consumption is smaller due to greater repayments. That is, the underlying rates of return become lower due to higher interest rates and repayments. At some point, rates of return no longer exceed borrowing costs, and new investment ceases. Consumers in this situation may neither borrow nor lend, or they may lend in financial markets or through financial institutions. Thus, looking at the household borrowing life cycle—borrowing at a young age, then later limiting borrowing, and eventually switching over more to lending rather than borrowing as rates of return on further investments fall—reflects the situation of many consumers as they age.

Juster and Shay's further extensions of the theory accounted for contract terms that reflect the unwillingness of many consumer lenders to finance the entire cost of consumer durables (i.e., they require down payments) and the existence of specialized lenders offering small amounts of unsecured credit at relatively high interest rates. Their conclusions also are consistent with empirical experience.<sup>4</sup>

Other than credit cards, consumer credit is generally offered on an installment basis, with a repayment schedule of periodic (typically monthly) payments that amortize the loan principal plus interest. Common automobile loans, student loans, and unsecured personal loans take this form. Since the funds for repayment depend on the consumer's uncertain ability to have available future income for payments, lenders commonly limit the amount of credit and adjust repayment terms. On nonrevolving credit, which was the common sort of consumer credit available when Juster and Shay were writing, creditors limited the amount of credit by requiring an initial down payment and a repayment term that was less than the expected economic life of the asset.

In their addition to lending theory, Juster and Shay discussed the possibility that a range of different lenders would develop in the marketplace, based upon their willingness to make riskier loans and charge higher lending rates. Consumers who prefer more credit than primary (low-cost) lenders are willing to offer them, or who are unable to borrow at all from these primary

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<sup>4</sup> This is the same Robert P. Shay of Columbia University who was an economic consultant and, in effect, the Chief Economist of the National Commission on Consumer Finance in 1971-2. F. Thomas Juster was a specialist in human capital formation and was Director of the large Institute for Social Research at the University of Michigan where much of the early research work on psychological and behavioral analysis of credit demand took place around the same time. Both were veterans of the National Bureau of Economic Research (NBER), then in New York and now in Cambridge, Massachusetts, where Shay had been full-time head of the consumer-credit research program in the 1960s and Juster the NBER's president.

lenders because of risk, may be able to borrow from supplemental lenders who provide additional credit at rates higher than market rates of primary lenders.

Looking at the marketplace today, there are many lenders that provide credit to riskier borrowers than prime borrowers. They include various kinds of subprime lenders such as higher-rate subprime credit card and auto lenders, small-loan companies, and payday lenders (see Chapter 5 for further discussion of them). Supplemental lenders' willingness to extend credit is not unlimited either, however. Consumers may sequentially increase borrowing from additional lenders who are willing to accept greater default risk, but the amounts are limited because no lender will make loans that are certain to default without compensation.<sup>5</sup> This is the basis of the idea of credit rationing (credit rationing is discussed further in Chapter 5).

Much has changed since Juster and Shay were writing in the early 1960s. For instance, advances in information availability through credit reporting agencies (CRAs, widely known as "credit bureaus") and in the technology to manage and analyze large amounts of information have improved ability of creditors to assess risk, making them on balance more willing to lend. Credit reporting through the credit bureaus is now much closer to comprehensive, and new information about individuals with little prior credit experience is under exploration. This has the potential to make overall predictions of future payment performance better still. Development of generic credit scores by the credit bureaus has made statistical evaluation relatively inexpensive and readily available to virtually all lenders. Marketplace competition has also relaxed lenders' equity requirements, as terms to maturity have lengthened for credit advances and down-payment requirements have grown smaller and less frequent. Today, many consumers are more able to finance a greater proportion of household investment through primary (low-rate) lenders like automobile and credit card lenders than in the past. Competition of lenders on a variety of margins including price, availability, and nonprice terms is discussed further in Chapters 6, 7, and 8.

At the same time, there are more secondary (higher-rate) lenders who are willing to lend supplementary amounts beyond that of primary lenders. The NCCF extensively studied the operations, costs, and credit supply of one group, traditional-installment cash lenders (known then as small-loan companies or licensed lenders). Pawnshops existed at the time of the NCCF, but they were uncommon enough in many places that the NCCF barely mentioned them. There also were considerable amounts of consumer credit available from retail stores and dealers, and the NCCF discussed retail-store credit at some length. This latter kind of consumer credit has dwindled greatly over the decades since then with the growth of bank credit cards.

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<sup>5</sup> See also David S. Bizer and Peter M. DeMarzo, *Sequential Banking*, JOURNAL OF POLITICAL ECONOMY, Vol. 100 (1992).

Today, unsecured credit on bank credit cards is more widely available, and many borrowers now use them in the manner that they used unsecured personal loans from finance companies in the past.<sup>6</sup> Competition has extended availability of bank credit cards to many consumers who in the past would have had difficulty qualifying for them. Because bank-card rates are generally lower than other unsecured consumer-credit rates, unsecured credit is now available to more consumers at a lower cost than in the past.

Nonetheless, more pawnshops exist nationwide than at the time of the NCCF, and whole new classes of secondary lenders. They include so-called “payday lenders” and vehicle-title lenders (sometimes called title pawns). Despite better technology and relaxed standards among primary lenders, many individuals still are unable to borrow from low-cost primary lenders who necessarily rely upon secondary lenders or who have no institutional credit available at all, including from secondary lenders.

Chapter 2 of this report showed that interaction between relative benefits and costs of credit has led to a lot of credit use over time. Further, although there is always a lot of discussions about conditions where credit arrangements go wrong, the Surveys of Consumer Finances show that the difficult cases are not in the majority. For instance, in the 2019 survey, 12.3 percent of consumers with any debt indicated being behind in any payments in the previous year but only 4.6 percent behind by 60 days.<sup>7</sup> Undoubtedly, at least some of these accounts paid off and produced a positive outcome, even if slowly. According to the 2019 survey, 2.0 percent of households had declared bankruptcy in the previous five years. This is not to minimize the woe that results for individuals who stumble in using consumer credit, but rather to point out that these cases are not the norm. Taken as a whole, evidence does not suggest an increase in the proportion of distressed borrowers over time, and discussion on Chapter 2 showed that aggregate repayments on consumer credit relative to household income have not increased in the past four decades (see Figure 2-3).

Measuring rates of return on consumer assets empirically is difficult, in large part because circumstances and needs of credit-using consumers vary widely, and outcomes differ as well. It seems difficult to argue, though, that returns can be anything other than positive for the most part, as theorized by Seligman, Hirshleifer, and Juster and Shay. For consumers themselves, it seems that benefits and costs of credit use are too well known not to be part of consideration and deliberation by credit users in most cases.

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<sup>6</sup> See Bizer and DeMarzo, 1992, *Sequential Banking*, op. cit. and Dagobert L. Brito and Peter R. Hartley, *Consumer Rationality and Credit Cards*, JOURNAL OF POLITICAL ECONOMY, Vol. 103, 400 (1995).

<sup>7</sup> Neil Bhutta, et al., Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances, FEDERAL RESERVE BULLETIN, September 2020, pp. 28-9.



It is not especially difficult for consumers to contemplate the potential benefits and costs of credit use. This would be especially true following their initial experiences, and evidence shows that following initial experiences, most consumers continue to use consumer credit over their life cycles. On the cost side, Truth in Lending, passed in 1968 and implemented the following year, was an attempt to simplify cost understanding. Evidence shows that many consumers use this information in the ways they prefer, annual percentage rates (APRs) for larger amounts of credit for longer periods of time, and dollar finance charges for small amounts for shorter periods (see further discussion in Chapters 5 and 7).

Seligman discussed flows of utilities from consumer investment in durable goods as early as 1927, and there have been attempts at direct empirical measurement at least since the time Juster and Shay were writing. For instance, in 1964 Poapst and Waters published their estimates of rates of return on consumer durable goods in the prestigious *Journal of Finance*.<sup>8</sup> Using methodology basically similar to how an investment analyst would study a commercial investment opportunity, they estimated rates of return on an automatic washer and dryer and a television set “for different rates of usage and periods of investment” (page 673). Costs of acquisition and operation were estimated with care, and their equations showed that discounted returns were quite high with reasonable estimates of usage and length of ownership. This would encourage household investment in durable goods using credit under many common circumstances. In their words, “Under such circumstances, the relatively minor variations in consumer-loan interest rates that general monetary policy might be able to produce are not likely to markedly alter the volume of consumer investment” (page 677).

The NCCF was aware of their approach and commissioned professors Dunkelberg and Stephenson of Stanford University Business School to examine it further.<sup>9</sup> In addition to looking at discounted flows of returns and costs together as a financial analyst would do (and Poapst and Waters did), they explicitly discussed how discounted net returns would also determine the pattern of acquisition of durable goods—namely, those with highest returns would likely be purchased first. They noted that this order could vary substantially among different consumers and households due to preferences and could vary over time, depending upon life-cycle stage. Due to the difficulties of ascertaining individual preferences, Dunkelberg and Stephenson directed their attention first to discounted net returns for a washer and dryer under varying usage conditions, similar to Poapst and Waters.

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<sup>8</sup> J. V. Poapst and W. R. Waters, Rates of Return on Consumer Durables, *JOURNAL OF FINANCE*, December, 1964.

<sup>9</sup> William C. Dunkelberg and James Stephenson, *Durable Goods Ownership and the Rate of Return*, TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, Vol. VI (Washington: Government Printing Office, 1975).

Dunkelberg and Stephenson then used their own analysis of returns on this particular pair of consumer durable goods as a benchmark. They found (like Poapst and Waters) that returns on an owned washer-dryer could be quite high in many cases and they concluded that returns on some other durable goods must be even higher. Dunkelberg and Stephenson discussed how estimates of rates of return for all durable goods in all circumstances would be difficult to make, but that ownership patterns suggested that many other goods, like refrigerators, were even more important than washers and dryers. If they were more important, this meant they provided even higher discounted returns (data on appliance holdings of families were from the 1967 Survey of Consumer Finances). Dunkelberg and Stephenson acknowledged and discussed the analytical difficulties with this conclusion (such as differences between home owners and renters), but their findings “suggest that such an approach could provide considerable insight into the purchasing behavior of consumers, when combined with data about the cost and availability of capital for various population subgroups” (page 46).

In 2001, Elliehausen and Lawrence provided simple simulations of potential returns on consumer purchases and concluded that they could be welfare enhancing even at payday-loan rates. For discussion, they assumed the example of an individual in need of a \$200 payday loan of two weeks for a fee of \$30 (APR of 391 percent). But public transportation to employment and additional time spent is also expensive, and under reasonable representations of such incurred costs, it was easy enough to show that the loan to repair the car now would be welfare enhancing on the basis of a financial analyst’s calculation of net present value. This would argue for the financial choice to borrow and make the repair.<sup>10</sup>

More recently, analysts at Georgetown University used an approach similar to Poapst and Waters, Dunkelberg and Stephenson, and Elliehausen and Lawrence to rank colleges according to graduates’ returns from attendance, taking college costs and student-loan costs into account.<sup>11</sup> Although similar in underlying methodology to the earlier studies, the Georgetown study includes simplified description of the underlying approach for those less familiar with financial analysis.

On the first page of the introduction, the authors lay out the essence of the issue about credit: “While much has been written about student debt, not all debt is bad. ... [Students] should consider the net present value (NPV) of their potential earnings, weighing the costs of investing in college now against the potential gains over time.” The report goes on to use data from the

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<sup>10</sup> GREGORY ELLIEHAUSEN AND EDWARD C. LAWRENCE, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND (Washington: Georgetown University Credit Research Center, Monograph Number 35, 2001).

<sup>11</sup> ANTHONY P. CARNEVALE, BAN CHEAH, AND MARTIN VAN DER WERF, A FIRST TRY AT ROI: RANKING 4500 COLLEGES, Georgetown University Center on Education and the Workforce, 2019. Other studies referenced there have also used the same basic approach.

U.S. Department of Education's College Scorecard, its online database providing information on earnings and debts of attendees at post-secondary schools across the country, to rank these institutions by net return on investment.

The approach in the education study is basically the same as undertaken by Poapst and Waters and by Dunkelberg and Stephenson but with more extensive data. The methodology of any such study requires care in properly stating gains and costs, and all these studies discuss what they have done. The Georgetown study necessarily works with medians, whereas the earlier studies of durable goods looked more at the range of individual outcomes under varying circumstances. The education study provides footnotes to related studies with some differences in their underlying estimating equations (such as employing different discount rates). But for the purposes here, the interesting aspect involves its basic conclusions, even though changing underlying data assumptions could lead to variations in outcomes.

In particular, the conclusions are certainly more favorable and optimistic than the conventional wisdom. It seems a widespread view exists that there is a student-loan debt crisis due to high costs and unfavorable economic outcomes associated with much of higher education today. Certainly, the nature of medians is that they are the center of the range of outcomes. There necessarily are going to be better and worse outcomes than the medians. Some will be much worse (and some much better). But the notable finding of the study is positive net present value of graduating at virtually all the institutions, even given the possibility of taking on debt: "Our findings buttress the idea that college is a worthwhile investment. Moreover, we take the position that college should be seen as a long-term investment" (page 4).

Clearly, investors in such undertakings (students and parents) should consider the potential benefits and costs, as with any investment. They certainly also should consider the likelihood that the student will finish the course. Even then, this is not to say that an outcome much worse than the median might occur in individual situations. Potential variation in outcomes involves the concept of risk, which is a characteristic of all investments. And certainly, no one ever liked a debt, due to undertaking an investment or not, but this does not mean the investment should not be undertaken.

The message in this section of this report chapter is that development of the neoclassical economic theory of consumer credit suggests a number of important ideas and that empirical evidence is consistent with them:

1. Consumers will be willing to borrow, depending upon rates of return and cost of borrowing available to them. For many households, using debt to finance certain purchases is a rational investment that provides an implicit rate of return that exceeds the cost of finance.

2. Borrowing will tend to be related to household investment undertakings like purchase of durable goods, acquiring human capital, capital improvements and repairs, and emergencies when credit use can be cost saving (or sometimes even life-saving).
3. There would be a life-cycle effect in credit use, since rate of return would be higher in most cases for younger consumers who have not developed a stock of assets and who have limited savings and lower incomes than they typically will have later in life.
4. Since credit involves an unknown future, there are risks in using it.
5. There will be both primary (lower-rate) and supplementary (higher-rate) lenders that develop (in absence of regulation to the contrary, discussed further in Chapter 5).
6. Secondary lenders supplement available credit for some borrowers and provide it to others for whom credit is not available from primary lenders.
7. There is risk in lending, and so there is an absolute lending limit even for secondary lenders due to economic credit rationing. This means that some individuals have only higher-rate credit available or no institutional credit available at all. (Credit rationing is discussed further in Chapter 5.)

Empirical evidence is broadly consistent with these conclusions, but this does not mean these conclusions complete the theory of demand for household credit or that they are not controversial. The next section looks at this question in still more detail.

### 3.3 Behavioral Theory and Neoclassical Economic Theory of Consumer Credit Demand

The standard neoclassical model of consumer demand for financial services has provided a theoretically robust and empirically well-verified model of consumer behavior for approximately a century, dating back at least to Irving Seligman's two-volume work on theory of consumer demand for installment credit in 1927. That model of consumer behavior provided the conceptual structure for the NCCF Report 50 years later. Today, the neoclassical model of consumer demand continues to provide reliable explanations and predictions of how consumers use financial products, including usage of alternative financial services by rationed consumers.

In recent years, however, some commentators have proposed an alternative model of consumer behavior grounded in the rubric of "behavioral economics" (BE). Assessing the application of behavioral economics with respect to consumer financial behavior is difficult because of

ambiguities in BE's claims. The traditional neoclassical approach to consumer demand for financial services offers a clear and determinate theory of consumer behavior and a set of direct, testable implications that can be used to assess the empirical validity of the model. In essence, the model assumes that consumers determine and pursue their own best interests, and tests of the model evaluate outcomes in the context of interests thus defined. The BE approach departs from this theory and replaces it with an inquiry into the quality of consumer preferences. Consequently, its testable implications are not always clear. Of particular concern, BE provides no clear analytical framework for determining which of hundreds of different, often contradictory biases and cognitive flaws might prevent consumers from making welfare-increasing decisions at different times in different contexts. The view of the Taskforce is that although some elements of BE show some potential to provide marginal insights to consumer financial decision making that might eventually be applicable to policy development, especially when determining how to best provide information to aid shopping decisions, BE remains too uncertain as a science and its policy implications too speculative to provide a firm foundation for policy development compared with the longstanding and well-developed neoclassical model of consumer finance.

This section of the report will not provide an exhaustive discussion of BE and its limits. Instead, the discussion here will focus on the unanswered questions of BE that should be addressed before the Consumer Financial Protection Bureau or other consumer protection agencies try to use it as an analytical tool for consumer protection in a fashion that will be likely to improve consumer welfare. Following a brief overview of BE and its sister field of behavioral law and economics (BLE), this section will discuss three unresolved difficulties with relying on BE and BLE as a basis for consumer financial protection policy: (1) questions about BE's economic foundations and the robustness of evidence for various biases, (2) the challenges for BE as a matter of theory in determining which of the hundreds of biases that have been alleged to exist would be relevant to assessing consumer decision making in any given choice context, including the strength of any biases relative to offsetting biases and how widespread those biases are in the population, and (3) the lack of empirical validation for the application of BE-derived hypotheses to explain observed decision making by consumers in financial contexts. Given the current state of knowledge about these issues, there seems to be little reason to believe that abandoning the neoclassical model of consumer finance would result in better consumer financial protection policy.

### 3.3.1 What is Behavioral Economics, Behavioral Law & Economics, and Consumer Demand for Financial Products

There appears to be no single accepted definition of what constitutes “behavioral economics.” Different definitions of the concept have been provided over time with different implications for economic analysis and public policy. The first approach simply recognizes that consumers face limited time, attention, and cognitive capacity, and these psychological constraints are relevant to predicting economic behavior. The second approach pushes further and argues that consumer decision making is riddled with biases and other cognitive limits that lead them to make errors systematically that make them worse off.

#### 1. Behavioral Economics and Psychology

At its most abstract level, BE can be defined as “a method of economic analysis that applies psychological insights into human behavior to explain economic decision making.”<sup>12</sup> To the extent that BE simply reflects an effort to apply psychology to the analysis of economic decision making or to model consumer decision making more accurately, there is nothing terribly controversial or novel about it. Beginning in the 1950s and continuing through the next few decades, economist Herbert Simon started to raise questions about the models of individual decision making that implicitly motivated much of the economic research of the era. Simon argued that time and cognitive attention are scarce resources that must be allocated across many different decision making tasks. Because acquiring information requires time and attention, all decisions—including consumer purchasing decisions—will be made with imperfect information. Decision makers will thus be “boundedly rational” instead of fully rational, in that they will always make decisions with less than full information.<sup>13</sup> From this insight, it was but a short extension of the theory to recognize that in a world of scarce time and attention, consumers will collect additional information up to the point where they subjectively believe that the marginal value of acquiring more information is equal to the marginal cost of doing so.<sup>14</sup>

In addition, many consumer decisions invariably include projections about the future. But the future is inherently uncertain. Uncertainty about the future is especially important when a consumer decides whether to use debt to make a purchase. For example, the decision whether to borrow to purchase a home or to attend college requires a projection about the expected return

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<sup>12</sup> See “behavioral economics” in Oxford Languages; see also “Behavioral Economics” in Investopedia.com, available in <https://www.investopedia.com/terms/b/behavioraleconomics.asp> (“Behavioral Economics is the study of psychology as it relates to the economic decision making processes of individuals and institutions.”).

<sup>13</sup> Herbert A. Simon, *Models of Bounded Rationality* (MIT Press, 1982).

<sup>14</sup> See George J. Stigler, *The Economics of Information*, J. of Pol. Econ. 213 (1961).

on those investments over time in light of the opportunity cost of alternatives. Taking out any loan involves risk of unexpected financial setback, such as illness or unemployment that could result in making it more difficult than expected to repay the debt; alternatively, an unexpected salary raise or stock market boom makes repayment easier and reduces the risk of nonpayment. Given the long-term implications of many decisions, consumers invariably face uncertainty with respect to any given investment. Moreover, no matter how rational the estimate of time at the point of the transaction might be, it inevitably will be wrong in some cases.

Using psychology to analyze consumer financial habits has been part of the field since its beginning. As early as 1889, Thorstein Veblen's theory of "conspicuous consumption" -that people's spending habits are intended to impress their neighbors-implicitly assumed that consumers would be willing to rely on debt to live above their means if necessary.<sup>15</sup> In his 1912 book *Charge It*, Irving Bacheller complained that access to credit induced people to live extravagant lifestyles that exceeded their actual financial means, leading many to financial ruin.<sup>16</sup> By 1938, in his famous book *The Folly of Instalment Buying*, Roger Babson railed about the predatory nature of consumer installment sales, which he believed seduced people into purchasing unnecessary luxuries—his example was a clothes washing machine—with the promise of easy monthly payments instead of saving up and paying cash.<sup>17</sup> Merchants were criticized especially harshly for supposedly preying on women by exploiting their supposed weaker level of psychological self-control (relative to men) and supposedly weaker math skills (again relative to men) to sell them goods on installment credit.<sup>18</sup> Although many of these theories were grounded more in pop psychology than scientific psychology, there is no shortage of voices today that echo sentiments that some groups of consumers are not fully capable of making wise choices for themselves—updated to remove sexist stereotypes about consumer incapacity.

The first comprehensive analysis of financial decision making from the perspective of modern psychology was provided by George Katona of the University of Michigan's Survey Research Center in his 1975 book *Psychological Economics*. Katona's investigation into consumer

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<sup>15</sup> Thorsten Veblen, *The Theory of the Leisure Class* (1889); see also Colin Campbell, *Conspicuous Confusion? A Critique of Veblen's Theory of Conspicuous Consumption*, 13 *Sociological Theory* 37, 41 (1995) (noting that Veblen's theory suggests that people would be "willing to run up a sizable debt in pursuing this goal" of using conspicuous consumption to obtain social status).

<sup>16</sup> Irving Bacheller, *Charge It: Or Keeping Up with Harry* (Bacheller, Harper & Brothers, 1912).

<sup>17</sup> See Roger W. Babson, *The Folly of Instalment Buying* 8-9 (1938). According to Babson, it was beyond the ability of "housewives to resist [the] temptation" of a new automatic laundry, and their husbands refused to "use the arithmetic" they were "taught in grammar school" or they would have not have yielded to the temptation. *Id.* Although little-known today, Babson was legendary during his era as a leading investor, one of the founders of investment theory, and most notably, as one of the few economists who predicted the 1929 stock market crash. Babson was the founder of Babson College.

<sup>18</sup> See Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* 166 (2001).

decision making revealed that in making financial decisions, people acted consistently with the predictions of the bounded rationality model of consumer decision making. Katona found that consumers tended to invest greater resources in planning and search when purchasing expensive durable goods, such as planning for the purchase, extensive search for information, and careful consideration of alternatives before making a purchase.<sup>19</sup> Moreover, consumers tended to invest more time and deliberation when purchasing a product that was especially expensive or important, a new or unfamiliar product, or when they were dissatisfied with a previous purchase.

Because information is costly and cognitive attention is scarce, consumers will always make purchase decisions with limited and imperfect information. As a result, it follows that consumers inevitably will make errors that could have been avoided had they had sufficient time and energy to research and search further. But assuming that consumers in their search activities typically turn first to those sources of information that produce most valuable and reliable sources of information, and later to less useful sources, consumers should, on average, make more correct, welfare-improving decisions than wrong decisions even with limited information. This approach also suggests that when decisions are repeated, consumers should learn from experience and thereby become better at making repeated decisions over time than decisions they make sporadically. In addition, because other consumers are simultaneously engaging in active search and evaluation, the process of trial and error and feedback associated with the market process should generate default rules that are responsive to consumer preferences.<sup>20</sup> The aggregation of experiences of many consumers making choices implicitly provides information to consumers as to the quality of competing providers and the usefulness of different products and services.

In turn, suppliers use advertising and other types of information to reduce the information costs to consumers of learning about those products and to highlight the terms and features of most interest to consumers. Sellers will have an incentive to highlight or nudge consumers toward existing and new products, attributes, and experiences that increase their satisfaction and

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<sup>19</sup> See DURKIN, et al., *supra* note 1.

<sup>20</sup> 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). This ongoing co-evolutionary process of consumer choice and market adaptation has been coined “ecological rationality” by economist Vernon Smith, reflecting the evolutionary and adaptive nature of the iterative process in a mutual process of discovery between consumer choice and market providers. Smith contrasts ecological rationality with constructivist rationality, such as the imposition of “nudge” rules by government central planners based on abstract economic theories instead of the emergent process of market dynamics. See Vernon L. Smith, *Rationality in Economics: Constructivist and Ecological Forms* 94-114 (2007); see also F. A. Hayek, *Competition as a Discovery Procedure*, 5 Q. J. Austrian Econ. 9 (2002).



welfare, thereby building brand loyalty and a positive market reputation.<sup>21</sup> “If, for example, consumers discount future consequences too heavily, sellers of products or services with long-term benefits have incentives to try to make those consequences more vivid and more salient to the consumer. If complex pricing plans are difficult for consumers to understand, firms in competitive markets have incentives to simplify those plans to attract customers.”<sup>22</sup> Sellers also have incentives to avoid the problem of “information overload, because it will undermine the message they are trying to convey,” and if some consumers are paralyzed by too many choices, some sellers will have the incentive to simplify available options.<sup>23</sup> Sellers also draw on the experiences of many other consumers to suggest new products and services that consumers might not be familiar with.<sup>24</sup> For all these reasons and others, even in a world of costly information, uncertainty, and limited time and attention, consumers in a competitive market should be expected generally to make decisions that are “correct” in the sense that they on average improve their welfare relative to the opportunity, even if their decisions do not appear to be “optimal” as defined by abstract economic principles.

The policy implications of using psychology to understand how consumers make economic decisions are straightforward. Most obvious, consumers develop useful shortcuts and heuristics to reduce information costs and uncertainty. They develop their own rules and habits to maximize their likelihood of being satisfied at lowest cost, and through their own iterative feedback process they typically retain rules that work to solve recurrent problems efficiently and abandon those that do not.<sup>25</sup> For example, consumers generally can rely on the value of a name brand or trademark as a signal of quality in situations where they lack the expertise to evaluate quality attributes directly or for experience goods where consumers will not learn about quality attributes until later.<sup>26</sup> Consumers often will be willing to pay a price premium to purchase from a provider with a quality brand when they believe that paying the premium to receive an implicit

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<sup>21</sup> 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).

<sup>22</sup> J. Howard Beales, *Behavioral Economics and Credit Regulation*, 11 J. L., Econ., and Policy 349, 359(2015).

<sup>23</sup> See J. Howard Beales III, *Consumer Protection and Behavioral Economics: To BE or Not to BE?*, 4 Competition Policy International 149, 166 (2008).

<sup>24</sup> See Smith and Zywicki, *supra* note 21. For example, as discussed below, current rules regarding enrollment in bank overdraft protection requires consumers to “opt-in” to coverage for ATM and debit card transactions. When initially asked about whether they would choose to opt-in, about half of respondents in one focus group indicated they would not. When prompted as to whether they would opt-in to coverage so as to have it available in case of an emergency, however, half of those who initially said they would not enroll changed their mind and opted-in. See ICFMacro, *Design and Testing of Overdraft Disclosures: Phase Two at 18-19* (Oct. 12, 2009) (research conducted in collaboration with Board of Governors of Federal Reserve).

<sup>25</sup> See Gerd Gigerenzer, *Why Heuristics Work*, 3 Perspectives on Psychological Science 20 (2008).

<sup>26</sup> See discussion in chapters 6 and 7.

assurance of quality will be less-expensive than the risk and cost of trying to ascertain directly the quality attributes of an unbranded alternative. In this sense, relying on brand names as a proxy for quality is a rational response to decision making under conditions of uncertainty and costly information.<sup>27</sup>

Government intervention can also provide a useful role within a framework of bounded rationality to improve the outcomes of consumer decision making. For example, government regulations that mandate disclosure of important product terms and features in a standardized format can reduce consumer shopping costs and facilitate competition, thereby improving the likelihood of beneficial outcomes for consumers.<sup>28</sup> On the other hand, the same psychological constraints of scarce attention, time, and energy place limits on the ability of consumers to process and understand mandated disclosures, and too many mandated disclosures can overwhelm and confuse consumers.<sup>29</sup> In addition, rules that prohibit fraudulent and deceptive communications can reduce cognitive processing costs for consumers by decreasing the prevalence of inaccurate information in the market that consumers will have to wade through to find accurate and useful information.

Nevertheless, despite the incentives for consumers to shop proactively and to collect useful information in a cost-effective manner, and despite their use of sensible information-processing shortcuts, they will nevertheless still make mistakes, either because of a lack of information or because uncertainty makes certain information unknowable at the time of the decision. Governmental policy interventions can help to reduce the frequency and cost of decision errors but cannot eliminate them.

## 2. Behavioral Economics as the Study of Consumer Biases and Errors

Behavioral economics as it has come to be known and practiced since Simon and Katona, however, has largely abandoned the project of seeking to understand how consumers actually make decisions under conditions of uncertainty. Instead, BE has become a research program of demonstrating and cataloging purported anomalies and biases in human reasoning and behavior. Under this approach, the researcher establishes the “correct” answer derived from some measure (consumer’s stated preferences or some stipulated outcome measure) and

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<sup>27</sup> See Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

<sup>28</sup> See Durkin, et al., *supra* note 1, at 129.

<sup>29</sup> See Omri Ben-Shahar and Carl E. Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (2014).

measures deviations from it and then grades consumers accordingly, often without considering alternative explanations as to whether the deviations may be rational in the real world.<sup>30</sup>

The modern field of BE is typically associated with a series of articles published in the 1970s by Amos Tversky and Daniel Kahneman, in which they purported to show a series of supposed biases and errors in individual psychology and problem solving.<sup>31</sup> Building on this foundation in psychology, economist Richard Thaler applied those concepts to economic decision making to document consumer deviations from the model of unbounded rationality, implicitly suggested by some economists as the model for measuring successful consumer decision making.<sup>32</sup> Although often referred to today as “biases” or “heuristics-and-biases,” sometimes BE is simply referred to as concerning itself with the study of individual “irrationality.” Although there is no precise definition of what constitutes an individual bias or anomaly, it is estimated that researchers have identified approximately 200 different biases that are said to affect individual decision making.<sup>33</sup> These include purported biases that could be relevant to understanding consumer use of financial products, such as framing, loss aversion, mental accounting, and hyperbolic discounting.

BE has primarily developed in a laboratory setting, divorced from consumers’ actual real-life decision-making tasks and contexts. Participants in experiments are often asked to perform somewhat arbitrary mental tasks that bear little resemblance to decisions they make in their day-to-day lives and real-world contexts, including financial decision making. Researchers design the experiments and then interpret the results. As a result, the researchers face the challenge of ensuring the laboratory experiment that they design actually tests the intended hypothesis, and then the researcher must understand the subject’s state of mind to interpret the results of the experiment. This requires the experimenter somehow posit a “correct” answer to a question that can be compared the answer chosen by the individual being studied, which can be “right” or “wrong.”

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<sup>30</sup> See Gerd Gigerenzer, *The Bias Bias in Behavioral Economics*, 5 Rev. of Behavioral Econ. 303, 303-04 (2018).

<sup>31</sup> See Amos Tversky and Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 Science 1124 (1973); Amos Tversky and Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 4 Cognitive Psychology 207 (1973); Amos Tversky and Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 Science 453 (1981); see also Daniel Kahneman, *Thinking, Fast and Slow* (2011).

<sup>32</sup> See Richard H. Thaler, *Misbehaving: The Making of Behavioral Economics* (W. W. Norton & Company, 2015).

<sup>33</sup> See Jeff Desjardins, *Every Single Cognitive Bias in One Infographic*, VisualCapitalist.com (Sept. 25, 2017), available in <https://www.visualcapitalist.com/every-single-cognitive-bias/>; Wikipedia, *List of Cognitive Biases*, available in [https://en.wikipedia.org/wiki/List\\_of\\_cognitive\\_biases](https://en.wikipedia.org/wiki/List_of_cognitive_biases).

As a result, a distinct characteristic—and challenge—of BE is that it abandons a fundamental precept of standard economics, the premise of “revealed preference.”<sup>34</sup> Originally associated with the work of economist Paul Samuelson, the theory of revealed preference holds that the best evidence of a consumer’s actual preferences is the actual purchase and other choices they make.<sup>35</sup> The postulate of revealed preference arises from the subjective nature of consumer preferences and diminishing marginal utility.<sup>36</sup> As a result, consumer preferences vary from person to person and even within the same person in different choice contexts.<sup>37</sup> It is only by making actual choices among available alternatives in a specific context at a specific time that an external observer can ascertain an individual’s preferences. In many instances, individuals might not know their true preferences themselves until forced to choose in a particular context.

BE rejects the idea that revealed preferences consistently are the best evidence of an individual’s “true” preferences. Instead, it contends that because of various biases and problems of self-control, a person’s true preferences can deviate from preferences revealed by actual behaviors. More important, BE theory implicitly holds that it is possible to ascertain an individual’s true preferences and to determine how revealed preferences, as inferred from the actual choices made under conditions of scarcity, deviate from true preferences.<sup>38</sup>

Although the process by which BE theorists go about ascertaining people’s true preferences as opposed to their revealed preferences is somewhat mysterious, they seem to use two mechanisms. First, they look at what people say are their preferences using surveys or choices made in the artificial environment of the economics laboratory. Second, it seems that BE theorists derive propositions they believe to be welfare-maximizing for the average person and then assume those are the preferences for everyone, regardless of their subjective preferences or

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<sup>34</sup> See Joshua D. Wright, *The Antitrust/Consumer Protection Paradox: Two Policies at War with Each Other*, 121 Yale L. J. 2216 (2012); see also Todd Zywicki, *The Behavioral Economics of Fixed-Rate Mortgages (and Other Just-So Stories)*, 21 Sup. Ct. Econ. Rev. 157, 189-90 (2014).

<sup>35</sup> See Paul A. Samuelson, *A Note on the Pure Theory of Consumers’ Behaviour*, 5 *Economica* 61 (1938); Paul A. Samuelson, *Consumption Theory in Terms of Revealed Preference*, 15 *Economica* 243 (1948).

<sup>36</sup> See Carl Menger, *Principles of Economics* (1871).

<sup>37</sup> See Thomas Sowell, *Knowledge and Decisions* 218 (1980) (“The real problem is that the knowledge needed is knowledge of *subjective patterns of trade-off that are nowhere articulated*, not even to the individual himself. I might *think* that, if faced with the stark prospect of bankruptcy, I would rather sell my automobile than my furniture, or sacrifice the refrigerator rather than the stove, but unless and until such a moment comes I will never *know* even my own trade-offs, much less anybody else’s.”); James M. Buchanan, *Cost and Choice: An Inquiry in Economic Theory* (1969).

<sup>38</sup> See Richard H. Thaler and Cass R. Sunstein, *Libertarian Paternalism*, 93 Am. Econ. Rev. 175 (2003); John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, *How are Preferences Revealed?* 82 J. of Public Econ. 1787 (2008).

whether they are value maximizing for them, such that any deviations are considered presumptively irrational.

Under criteria for rationality derived this way, many actual choices made by individuals who believe they are completely rational in that they are consistent with their preferences, resources, and constraints (and visibly would seem to be rational under these conditions) nevertheless could be classified as not rational. For example, many BE theorists claim to have discerned that consumers have a true preference to save more money for retirement than they currently do based on their expressed views in surveys, but because of a variety of supposed cognitive biases, they often fail to carry through on these plans.<sup>39</sup> At the same time, however, an overwhelming number of people also say they would like to work less, borrow less, save for other goals (such as a home, emergency savings, or their children's college education), and spend money on goods and services that would make their lives easier and more comfortable, such as a reliable car, new roof, refrigerator, furniture, rent, or utilities.<sup>40</sup> And, as discussed in Chapter 12, the vast majority of Americans save enough or more than enough for retirement, and of those who do not currently save for retirement are pressed by other financial priorities or saving for other purposes. One survey by a major provider of retirement plans found that roughly 80 percent of employees were participating in the employer's plan, and those who were not participating were ineligible, paying down consumer or student-loan debt, saving for some other purpose (such as emergency savings, a home, or college), or were using all their income to meet current needs.<sup>41</sup> By contrast, a trivial minority of those who at any given time are not participating in a retirement plan do so for reasons emphasized by BE, such as not "taking the time to do it"—only 6 percent of the 20 percent of employees who were not participating offered that response, or about 1.2 percent of all employees in the sample.<sup>42</sup> Thus, surveys and games played in a laboratory do not simulate decisions made subject to real-world constraints and opportunity cost in real-world contexts and it is not viable to claim to be identifying an individual's "true" preferences without accounting for the limits of opportunity cost and constraints, including resource constraints.

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<sup>39</sup> It is not specified how widespread this deviation between intended and executed plans must be for it to be considered problematic. It is not clear why only those who save too little for retirement might be considered as exhibiting biased decision making whereas those who save too much are not, even though both groups bear costs from their choices.

<sup>40</sup> 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).

<sup>41</sup> Transamerica Center for Retirement Savings, 16<sup>th</sup> Annual Transamerica Retirement Survey: A Compendium of Findings About American Workers 31 (Aug. 2015), [https://www.transamericacenter.org/docs/default-source/resources/center-research/16th-annual/tcrs2015\\_sr\\_16th\\_compendium\\_of\\_workers.pdf](https://www.transamericacenter.org/docs/default-source/resources/center-research/16th-annual/tcrs2015_sr_16th_compendium_of_workers.pdf)

<sup>42</sup> *Id.*

Surveys and games played in a laboratory do not simulate decisions made subject to real-world contexts, and it is not viable to claim to be identifying an individual's true preferences without accounting for the reality of opportunity cost and constraints. Can economists confidently conclude that it is "irrational" to spend money on a memorable wedding honeymoon today because the "true self" would rather save to have marginally more money to spend when they are a 75-year-old widow/widower? Indeed, a nontrivial number of people do not even survive until retirement age; there is a clear survivor bias in asking only those who do survive whether they wish they had saved more money for retirement. The probability that a 30-year-old will die before they reach the age of 70 is 15 percent for women and 20 percent for men.<sup>43</sup> It is a reasonable assumption that had those individuals known they would die before their retirement was reached, their true preferences would have been to increase their consumption while alive instead of deferring consumption until they were deceased.

Even when behavioral economists do not assume they know true preferences, they frequently compare their findings to the optimal choice that a fully informed person facing no costs of information, no costs of decision making, and no uncertainty would make. That, however, assumes away the economic realities that motivated BE in the first place. It offers no useful insights into public policy in particular, any more than the observation that if people were unconstrained by their incomes, they would purchase more Mercedes and fewer Volkswagens. Similarly, it is a reasonable assumption that we would all make different decisions if we knew the future with certainty.

### 3. Behavioral Law & Economics

For current purposes, behavioral law and economics (BLE) can be understood as the effort to apply the supposed insights of BE to implement legal and policy goals.<sup>44</sup> BLE claims that the insights of BE can be applied in specific institutional choice contexts to identify market failures caused by individual cognitive biases and mistakes and to develop corrective policies that will increase consumer welfare. The premise of BLE is that policymakers can (1) predict *which* biases will apply and *how* those biases will manifest themselves in any particular choice context, (2) those biases are *systematic*, and (3) government regulation can improve outcomes.<sup>45</sup>

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<sup>43</sup> See Any Kiersz, *This Is When You're Going to Die*, Business Insider (Mar. 21, 2014), <http://www.businessinsider.com/social-security-life-table-charts-2014-3>.

<sup>44</sup> See Christine Jolls, Cass R. Sunstein, and Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stanford L. Rev. 1471 (1998).

<sup>45</sup> These assumptions appear to be implicit in BE as well.

For example, consider a well-trod BLE hypothesis about the supposed propensity for consumers to overborrow on their credit cards. According to BLE theorists, “many” consumers believe each month that they are going to pay off their outstanding balance at the end of the month but fail to do so, leading them to revolve their debt and pay finance charges. This recurrent pattern of mistakes occurs because consumers supposedly suffer from a variety of cognitive biases, such as “overoptimism” bias, hyperbolic discounting, and others that lead them to overestimate their likelihood of paying off their credit card bill in full each month.<sup>46</sup> In addition to consumers’ being mistaken about their propensity to revolve balances on average, consumers’ errors are posited to be systematically biased in the sense that consumers are substantially more likely to be overoptimistic about their propensity to pay off their balance each month (i.e., they believe they will pay off the bill and do not) than they are to be underoptimistic (i.e., they believe they are going to revolve balances but do not).

In the context of credit cards, therefore, BLE makes three predictions that distinguish it from standard economics about choice under uncertainty: First, many consumers make mistakes; second, those mistakes are systematically biased toward borrowing too much and saving too little; and third, because of the deep-seated and unconscious nature of these biases, consumers do not learn from their mistakes. Neoclassical economics of decision making under uncertainty argues the opposite: First, Consumers on average make welfare-improving decisions and are more likely to do so as the cost of errors increases; second, errors will be systematically unbiased; and third, consumers learn from their mistakes and update their choices going forward, and the larger the costs of their mistakes the more likely they are to learn.

One can thus visualize the model of consumer behavior from neoclassical economics as consumers having a distribution of outcomes centered on the “correct” answer, with errors being symmetrical in distribution. To use the example of credit cards, most consumers would be expected to accurately predict their likelihood of revolving their balances each month, with the distribution of errors being systematically unbiased (i.e., consumers are just as likely to underestimate their probability of revolving as to overestimate their probability). The BLE model, by contrast, would predict that the majority of consumers (or at least a sizable and identifiable minority) would err in their expected likelihood of revolving balances at the end of the month and that those errors would be systematically biased (i.e., consumers would be much more likely to be overoptimistic about their likelihood of paying off their balances than to be underoptimistic).<sup>47</sup>

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<sup>46</sup> See Oren Bar-Gill, *Seduction by Plastic*, 98 NW L. Rev. 1373 (2004).

<sup>47</sup> Empirical analysis of these competing hypotheses is discussed below.

### 3.3.2 Difficulties with the BE and BLE Models of Consumer Financial Protection

The remainder of this part of the chapter will discuss three challenges to the prospect of BE and BLE emerging as a viable alternative to the traditional economic model of demand for consumer finance that has motivated economic research and policymaking for the past century: (1) Ongoing questions about the robustness and context-dependent nature of many of the supposed biases and anomalies that BE theorists have claimed to have identified in individual decision making; (2) BLE's questionable theoretical foundations with respect to being able to determine and predict which of the nearly 200 biases that have been identified will apply in specific choice contexts, and the direction and magnitude of those influences; and (3) BLE's lack of empirical support to date for its hypotheses about consumers' use of financial products and services.

#### 1. BE's Contested Scientific Foundations

Many of the underlying scientific premises of BE remain highly contested. As BE has matured from a niche field of *ad hoc* anomaly spotting to a more mature field of claimed generalizable insights about human decision making, many of the original claims of BE have become less secure rather than more secure, including growing questions about the existence, robustness, and context-dependent nature of many supposed individual cognitive biases. Indeed, even co-founder Daniel Kahneman has attested to the ongoing reevaluation process of early conclusions, admitting that he “placed too much faith in underpowered studies,” of which he was not sufficiently skeptical at the time and which have failed to be replicated by independent researchers.<sup>48</sup>

These problems with BE stem from a variety of sources, including problems in experimental design and the challenges inherent in interpreting raw data from observed laboratory findings by attaching a motivation or bias to explain the finding. Hypotheses are often poorly specified for testing in artificial experimental settings, and alternative hypotheses that might explain the observed behavior are often ignored. Many initially identified biases have come to be recognized as context dependent or contingent on the specific conditions of the experimental design. In other instances, contrary results of some experiments have been ignored in reporting on the claimed overall robustness of the evidence in support of a proffered bias. In many instances, the willingness of BE and BLE scholars to engage in *ad hoc* and *ex post* rationalizations to interpret observed findings as confirming BE hypotheses might be explained by reference to various

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<sup>48</sup> See Ulrich Schimmack, Moritz Heene, and Kamini Kesavan, *Reconstruction of a Train Wreck: How Priming Research Went off the Rails*, Replicability-Index Feb. 2, 2107), available in <https://replicationindex.com/2017/02/02/reconstruction-of-a-train-wreck-how-priming-research-went-off-the-rails/>.



potential biases, such as confirmation bias and motivated reasoning.<sup>49</sup> Abandoning the theory of revealed preferences as the best evidence of consumers' actual subjective preferences also raises the potential for the observer to inadvertently believe that their own preferences are actually the true preferences of the subject.

The inability to replicate leading findings in a variety of scientific fields has given rise to what has been labeled a “replication crisis” or “reproducibility crisis” across the sciences.<sup>50</sup> The replication scandal has hit the field of psychology especially hard, as one 2015 effort found that fewer than half of leading studies published in three psychology journals could be replicated by independent researchers.<sup>51</sup> The problem of replication has not spared behavioral and experimental economics: One effort to replicate the top-line statistical finding from 18 laboratory-experimental papers published in *The American Economic Review* and the *Quarterly Journal of Economics* between 2011 and 2014 was unable to do so in 40 percent of cases.<sup>52</sup> This replication concern leaves aside the additional difficulty of interpreting those results and their relevance to real-world choice contexts.

Beyond the question of the ability to replicate earlier experimental economics studies lies a larger issue—the contested scientific basis for many of the most important biases that have provided the intellectual foundations of BE. These include such linchpins of BE as the “endowment effect,” “loss aversion,” and a variety of observed behaviors that are often interpreted as reflecting cognitive biases or errors in human decision making but can be explained more persuasively by other explanations.

The “endowment effect”—overestimating the value of one’s possessions—was once considered to be one of the best known and most robust theories in behavioral economics, serving as the basis

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<sup>49</sup> See Todd J. Zywicki, *The Behavioral Economics of Behavioral Law & Economics*, 5 Rev. of Behavioral Econ. 439 (2018).

<sup>50</sup> The “replication crisis” can be distinguished from the problem of outright fraud in that has led to the withdrawal of many leading papers, including several research findings that were later withdrawn that BLE scholars have relied on in their own research. See Todd Zywicki, *Does the Growing Exposure of Scientific Fraud in Social Psychology have Implications for Behavioral Law & Economics*, The Volokh Conspiracy (Oct. 8, 2012), available in <http://volokh.com/2012/10/08/does-the-growing-exposure-of-scientific-fraud-in-social-psychology-have-implications-for-behavioral-law-economics/>.

<sup>51</sup> See Open Science Collaboration, *Estimating the Reproducibility of Psychological Science*, 349 Science 943 (2015) (Issue 6251, August 28, 2015).

<sup>52</sup> See Colin Camerer, et al., *Evaluating Replicability of Laboratory Experiments in Economics*, 351 Science 1433 (Issue 6280, Mar. 25, 2016). The authors note that the finding that a “significant effect in the same direction as in the original study” could be replicated in only 61% of the cases was “considerably lower than the replication rate of 92% (mean power) that would be expected if all original effects were true and accurately estimated.” It is not evident from the report how many of those experiments specifically tested BE-related hypotheses and whether those findings were more robust than other types of experiments.

for hundreds of articles in economics, law, and other fields.<sup>53</sup> Analysis by Charles Plott and Kathy Zeiler, however, has cast doubt on the existence and robustness of a stable endowment effect, attributing positive findings to elements of experimental design, not a robust, context-independent finding of a stable preference.<sup>54</sup> As a result, the positive finding of an endowment effect is believed to be highly contingent on the design of the experiment, and variations in experimental design can produce multiple outcomes.<sup>55</sup>

Leaving aside questions about the robustness of findings of an endowment effect in economic experiments, economist Jonathan List has raised questions about the degree to which the endowment effect can be generalized as being relevant to behavior outside the artificial-choice environment of the economics laboratory.<sup>56</sup> In particular, List found that the behaviors that had been identified as evidence of an endowment effect became weaker as people developed experience making choices in real markets and had incentives to improve their decision making. Subsequent research by Engelmann and Hollard concluded that behavior that was attributed to the endowment effect might have actually reflected some uncertainty about the trading procedure itself, perhaps as a result of perceived transaction costs or risks.<sup>57</sup> Manne and Zywicki have noted that even if the endowment effect exists, this would not meaningfully affect market efficiency, because it would create a profit opportunity for entry by those who are not subject to those biases, such as corporations.<sup>58</sup> Overall, analysis has raised doubts about the existence and strength of the endowment effect in general; and, even if behavior consistent with the theory is observed, the applicability of the endowment effect is questionable in contexts where individuals have incentives to act rationally and opportunities to learn from experience.

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<sup>53</sup> See Jack Knetsch, Fang-Fang Tang, and Richard Thaler, *The Endowment Effect and Repeated Market Trials: Is the Vickrey Auction Demand Revealing?*, 4 *Experimental Economics* 257 (2001) (calling the endowment effect “one of the most robust findings in the psychology of decision making”).

<sup>54</sup> See Charles R. Plott and Kathy Zeiler, *Exchange Asymmetries Incorrectly Interpreted as Evidence of Endowment Effect Theory and Prospect Theory?*,

97 *Am. Econ. Rev.* 1449 (2007); Charles R. Plott and Kathy Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the “Endowment Effect,” Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 *Am. Econ. Rev.* 530 (2005); see also Charles R. Plott and Kathy Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the “Endowment Effect,” Subject Misconceptions, and Experimental Procedures for Eliciting Valuations: Reply*, 101 *Am. Econ. Rev.* 1012 (2011).

<sup>55</sup> See Durkin, et al., *supra* note 1, at 146-48.

<sup>56</sup> See Jonathan A. List, *Does Market Experience Eliminate Market Anomalies? The Case of Exogenous Market Experience*, 101 *Am. Econ. Rev.* 313 (2011); Jonathan A. List, *Neoclassical Theory Versus Prospect Theory: Evidence from the Marketplace*, 72 *Econometrica* 615 (2004); Jonathan A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 *Q. J. Econ.* 41 (2003).

<sup>57</sup> Dirk Engelmann and Guillaume Hollard, *Reconsidering the Effect of Market Experience on the “Endowment Effect,”* 78 *Econometrica* (2010).

<sup>58</sup> See Geoffrey A. Manne and Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, 10 *J. L. Econ. & Policy* 555 (2014).

The endowment effect is grounded in another foundational premise of BE and BLE, the related idea of “loss aversion,” (i.e., that losses are systematically experienced as being more psychologically impactful than gains).<sup>59</sup> The idea of “loss aversion” has been proffered as the basis for a variety of observed behaviors and biases asserted to be inconsistent with neoclassical economics, including the endowment effect, “inequality aversion,” and the “status quo bias.”<sup>60</sup>

A review by Gal and Rucker of experimental studies supposedly finding evidence of loss aversion concluded that the claim of a stable “loss aversion” bias was: (1) often a manifestation of the experimental design used to test the concept, and (2) a misattribution of the motivations behind observed behavior to loss aversion instead of some other explanation.<sup>61</sup> According to Gal and Rucker, most of the experiments that claim to find evidence for loss aversion are fundamentally flawed in that they offer individuals just two choices—either to trade their existing endowment or to keep it.<sup>62</sup> When offered only these two choices, some 90 percent of participants choose to keep their initial endowment, regardless of what it is. But this result ignores a third possibility—that many participants in the experiment are largely indifferent between either of the two choices provided to them. Changes from the status quo require psychological and intellectual effort to undertake. Where individuals are indifferent between possessing two low-value and arbitrarily assigned entitlements, even a small amount of transaction costs or friction would be expected to be sufficient to obstruct trading. Indeed, when offered the third option of “indifferent between options,” and not just the binary choice of whether to trade or not, a majority of participants select it. This suggests their decision not to trade has little to do with the presence of a supposed biases such as the endowment effect or loss aversion, but instead to the participants’ absence of a preference for one of the items over the other, such that even a modest investment of time and energy to think about trading one item for another of comparable market and subjective value, is larger than any gains that might be achieved. Gal and Rucker conclude the concept of loss aversion is not stable to different choice contexts: “Our main conclusion is that the weight of the evidence does not support a general tendency for losses to be more psychologically impactful than gains (i.e., loss aversion). Rather, our review suggests the need for a more contextualized perspective whereby losses sometimes loom larger than gains,

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<sup>59</sup> See Daniel Kahneman and Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979). Loss aversion is also referred to as “prospect theory.”

<sup>60</sup> See Colin F. Camerer, *Three Cheers—Psychological, Theoretical, Empirical—For Loss Aversion*, 42 *J. Marketing Research* 129 (2005) (reviewing various theories linked to the premise of “loss aversion”).

<sup>61</sup> David Gal and Dereck Rucker, *The Loss of Loss Aversion: Will It Loom Larger Than Its Gain?*, 28 *J. of Consumer Psychology* 497 (2018); see also David Gal and Dereck Rucker, *Loss Aversion, Intellectual Inertia, and a Call for a More Contrarian Science: A Reply to Simonson & Kivetz and Higgins & Liberman*, 28 *J. Consumer Psychology* 533 (2018).

<sup>62</sup> In most experiments of the endowment effect and loss aversion, individuals are divided into two groups and randomly endowed with two arbitrary alternatives of small and more or less equivalent market value, such as a pen or coffee mug and then are invited to trade.

sometimes losses and gains have similar psychological impact, and sometimes gains loom larger than losses.”<sup>63</sup>

As reported by Eldad Yechiam in a comprehensive review of studies on loss aversion, there is no consistent finding that individuals express a systematic asymmetry in their psychological experience of losses and gains.<sup>64</sup> Many of the studies that have purported to find evidence of loss aversion have failed efforts at replication. Moreover, “researchers have found a host of other asymmetries between gains and losses that occur simultaneously with no loss aversion. ... All these asymmetries were found to emerge in task conditions where individuals did not overweight losses compared to gains, which further suggests that the effect of losses on the human mind cannot be singly captured by loss aversion.”<sup>65</sup> Yechiam concluded that where behavior is found that is consistent with the theory of loss aversion, it actually reflects an aversion to “high-stakes losses” and “gain/loss neutrality for small-to-moderate losses,” not a uniform tendency toward loss aversion.<sup>66</sup> Moreover, Yechiam notes the findings of some of these studies have been systematically misrepresented to reflect loss aversion, though they did not actually find it. In many instances, where behavior consistent with loss aversion is observed, that behavior could be explained by alternative theories that are at least as intuitively persuasive as loss aversion. As Yechiam concluded<sup>67</sup>:

The current review suggests that the literature concerning losses existing in and prior to Kahneman and Tversky has been overinterpreted by Kahneman and Tversky and in the subsequent literature. First of all, the preponderance of loss aversion ... seems to have been exaggerated, as this behavioral regularity was not observed in several studies, including studies that were cited as supporting loss aversion. Second, loss aversion in estimated utility functions was only observed in studies focusing on very high amounts and not in studies of small amounts. Third, even in the studies focusing on high amounts ... loss aversion was not observed for about half of the participants for the smallest amounts used, but only for higher amounts. These findings are difficult to reconcile using a “tilted scales” metaphor of losses

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<sup>63</sup> See Gal and Rucker, *Loss of Loss Aversion*, *supra* note 61, at 498.

<sup>64</sup> See Eldad Yechiam, *Acceptable Losses: the Debatable Origins of Loss Aversion*, 83 *Psychological Research* 1327 (2019).

<sup>65</sup> *Id.* at 1329.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 1336 (citations omitted).

being overweighted compared to gains; nevertheless, they were overinterpreted to indicate a general asymmetry in the utility function for gains and losses.<sup>68</sup>

Psychologist Gerd Gigerenzer has extensively documented problems with many of the supposed biases and anomalies that BE theorists have attributed to individual decision making. As Gigerenzer observes, from its initial promising roots in Simon’s admonitions to take the ideas of bounded rationality more seriously in economic thought, BE has evolved under the influence of the heuristics-and-biases literature into a research program to identify deviations from the neoclassical economics paradigm, “or what it took that paradigm to be. Experimenters aimed at demonstrating ‘anomalies’ and ‘biases’ in human behavior.”<sup>69</sup> As such, BE research has built its findings on a hodgepodge of findings drawn from unrepresentative choice contexts, generalized context-dependent findings to broader focus, failed to consider alternative hypotheses for observed behavior, and in some instances simply misunderstood the phenomena they were purporting to examine. Gigerenzer concludes that this redefinition of BE, away from its origins in understanding how people generally think and approach economic decisions toward an agenda-oriented approach of identifying and cataloging supposed biases, has led BE to its own problem—the “bias bias,” or “the tendency to see systematic biases in behavior even when there is only unsystematic error or no verifiable error at all.”<sup>70</sup>

Gigerenzer describes numerous supposed biases identified by BE researchers that, in fact, are not biases at all, such as the “hot hand” and “gambler’s fallacies.” BE researchers often also frequently assume that “logically equivalent frames” are “informationally equivalent,” when in fact people construe information through a lens of shared communication and poorly worded questions that leads to erroneous interpretations of results.<sup>71</sup> Unsystematic errors are often believed by researchers to be systematic errors. Numerous other similar methodological and logical problems have been identified as plaguing the findings of BE.<sup>72</sup>

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<sup>68</sup> Plott and Zeiler similarly noted that despite claims that the presence of the endowment effect was robust and important, a substantial minority of experiments had failed to find a gap between participants’ willingness to pay and willingness to accept. *See* Plott and Zeiler, *supra* note 54 (noting that 12 of 39 experiments of the endowment effect failed to confirm the hypothesis even under their chosen experimental design).

<sup>69</sup> *See* Gerd Gigerenzer, *The Bias Bias in Behavioral Economics*, 5 *Rev. of Behavioral Econ.* 303, 304 (2018).

<sup>70</sup> *Id.* at 307.

<sup>71</sup> For example, Gigerenzer notes that in the famous “Linda Problem,” which asks whether it is more likely that a hypothetical woman named “Linda” is just a “bank teller” or a “bank teller active in the feminist movement,” the inclusion of the additional seemingly-extraneous information about Linda might logically be interpreted by participants in the study as asking for a different judgment than that intended by the experimenter. *See* Ralph Hertwig and Gerd Gigerenzer, *The “Conjunction Fallacy” Revisited: How Intelligent Inferences Look Like Reasoning Errors*, *J. of Behavioral Decision Making* (1999).

<sup>72</sup> For an extensive discussion, *see* Durkin, et al., *supra* note 1, at chapter 4.

According to Gigerenzer, what is often believed by BE theorists to be evidence of biases or irrationalities can be more accurately understood as explaining how individuals actually make decisions under uncertainty, as opposed to the implicit assumption of decisions made under risk where all states of the world are potentially known in a probabilistic fashion.<sup>73</sup> In a context of uncertainty, as opposed to risk, so-called “fast-and-frugal heuristics” often lead to superior decision making compared with efforts to create more elaborate optimizing decision rules.<sup>74</sup> In fact, efforts to apply more elaborate decision-making rules can lead to worse outcomes. Decision making in the context of uncertainty has also been shown to explain what is often claimed to be evidence of hyperbolic discounting (i.e., the systematic preference for an immediate reward over a larger future award).<sup>75</sup>

Based on the state of knowledge about BE and the “biases-and-heuristics” research program, minimal confidence can be given to a viable alternative framework to analyze consumer financial economics and consumer financial protection policies, compared with the traditional model developed at the beginning of this chapter. Claims about the existence, strength, and frequency of various biases in the population are highly suspect. Many of the biases that are claimed to exist are potentially explained by alternative hypotheses about individual reasoning and behavior. Where potential biases are found to exist, they are usually context dependent, and it is difficult to identify *ex ante* which context can be expected to bring forth which biases and in what direction. For example, as noted, there are severe doubts about whether the “loss aversion” bias exists at all. But even if it does, it is context dependent, as different contexts produce behavior at different times that is consistent with loss aversion, gain preferring, or gain-loss neutrality. It is difficult to see how this somewhat *ad hoc* collection of purported biases and anomalies can provide a reliable foundation for a coherent system of consumer financial protection.

## 2. Weaknesses in BE’s Theoretical Foundations as Applied in Particular Choice Contexts

Even if BE’s foundational concepts are assumed to be empirically sound and generalizable beyond their specific laboratory contexts, there are profound challenges to applying those laboratory-induced findings to understand consumer demand for financial products in real-world choice contexts. As a matter of theory, at least three unresolved difficulties can be

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<sup>73</sup> *Id.* at 329.

<sup>74</sup> See Gerd Gigerenzer and R. Selten, *Bounded Rationality: The Adaptive Toolbox* (2001); see also Gerd Gigerenzer, *How To Explain Behavior?*, *Topics in Cognitive Science* 1 (2019); Gerd Gigerenzer and Henry Brighton, *Homo Heuristics: Why Biased Minds Make Better Inferences*, 1 *Topics in Cognitive Science* 107 (2009).

<sup>75</sup> See Peter D. Sozou, *On Hyperbolic Discounting and Uncertain Hazard Rates*, 265 *Proceedings of the Royal Society Lond. B.* 2015 (1998); J. Doyne Farmer and John Geanakoplos, *Hyperbolic Discounting Is Rational: Valuing the Far Future with Uncertain Discount Rates*, Cowles Foundation Paper No. 1719 (Yale 2009).

identified to general usage of BE as a theoretical framework for deriving a general theory of consumer demand for financial products and services: (1) selecting *which* of multiple potential biases supposedly applies in a given choice context and how to determine which bias will predominate if multiple different biases might apply, (2) *how* any specific biases will apply in a given choice context and what to do if different biases contradict one another, and (3) the problem of assessing the welfare effects of policies for consumers, especially given the abandonment of revealed preferences as the yardstick for measuring consumer welfare and moving toward untestable or even tautological hypotheses. Consider each of these three concerns in turn.

#### **A. WHICH BIASES APPLY IN A PARTICULAR CONTEXT?**

First, BE has no discernible or scientific theory of how to predict in any given choice context which of the nearly 200 different potential biases might apply and the magnitude of their effects. Indeed, BE's methodology on this point appears to be the opposite of standard economic methodology: Instead of specifying a model and its testable hypotheses, BE begins with an isolated observation of some consumer behavior that is asserted to be welfare reducing and inconsistent with the individual's true preferences, then retroactively attaches an *ad hoc* BE-based label to explain the purported choice of suboptimal behavior.<sup>76</sup> In many instances, however, the observed behavior can be understood as a rational response to the individual's constraints and choice context.<sup>77</sup> For example, in predicting whether someone is going to take an action such as starting a new business or buying a home, how does the observer know whether the individual is likely to be motivated by the "status quo bias" on one hand—which would suggest undue passivity, pessimism, "loss aversion," and inertia about starting the new business—or the "optimism" or "wishful thinking" bias on the other—which would predict to make him or her unduly optimistic about the new business or the future expected path of home prices? Or what if different purported biases apply to different people in different ways at different times in different choice contexts? How is a policymaker supposed to predict as a matter of theory whether those biases will cancel out, exacerbate each other, or some combination for different people at different times?

The problem becomes even more difficult when the policymaker must weigh two or more competing policy options through the lens of BE. Consider the issue of mortgage choice and its relationship to the 2008 mortgage-induced financial crisis. Leaving aside obvious problems of fraud in the marketing and origin of some mortgages during that period, many consumers simply made mistakes about the wisdom of home-buying and mortgage choices largely because of mistaken assumptions about the future expected path of home prices and interest rates. In

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<sup>76</sup> See Zywicki, *Just-So Stories*, *supra* note 34, at 187-89.

<sup>77</sup> *Id.*

particular, some consumers took out higher-cost subprime mortgages with adjustable interest rates based on unduly optimistic projections about the future path of housing prices, leading them to take on greater leverage and pay a higher price to purchase a home than was warranted in light of subsequent developments.<sup>78</sup> Some commentators have attributed the boom in housing prices and use of subprime mortgages to a grab bag of widespread behavioral biases that supposedly led to those mistakes.<sup>79</sup>

Regardless whether they held prime or subprime mortgages, homeowners who took out adjustable-rate mortgages when the Federal Reserve initially drove down short-term interest rates in the early 2000s obviously suffered when the Fed reversed course a few years later and dramatically raised rates.<sup>80</sup> But many consumers also make mistakes and suffer welfare losses, judged after the fact, when they decide to take out a traditional 30-year, fixed-rate mortgage with an unlimited right to prepay.<sup>81</sup> Homeowners pay a substantial interest-rate premium for a fixed-rate mortgage that can amount to thousands or tens of thousands of dollars over the life of the mortgage to purchase long-term insurance against future increases in interest rates.<sup>82</sup> Consumers who purchase a home using a fixed-rate mortgage suffer losses if interest rates fall and they are locked into a higher rate (or have to spend a substantial sum in closing costs to refinance) or sell their house and move earlier than expected (thus losing the benefit of the premium they paid for long-term interest-rate stability). If their house has declined in value in the meantime and they are in a negative equity position, they will be able to refinance into a lower rate only if they can also come up with sufficient amounts of cash to cover the shortfall on the prior mortgage.<sup>83</sup>

It is not difficult to identify homeowners who suffered wealth losses because they chose an adjustable-rate mortgage instead of a fixed-rate mortgage and then attribute those decisions *post hoc* to the presence of some bias. But it also is not difficult to identify homeowners who suffered losses because they chose the opposite and attribute those *post hoc* to the same or other

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<sup>78</sup> Although such behavior may be rational in asset markets where valuations are determined by parties' expectations of future price behavior, not underlying use values, giving rise to "asset bubbles." See Steven D. Gjerstad and Vernon L. Smith, Rethinking Housing Bubbles: The Role of Household and Bank Balance Sheets in Modeling Economic Cycles (2014).

<sup>79</sup> See Oren Bar-Gill, The Law, Economics, and Psychology of Subprime Mortgage Contracts, 94 Cornell L. Rev. 1073 (2009).

<sup>80</sup> See See Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, Mercatus Center Working Paper No. 09-35 (Sept. 2009).

<sup>81</sup> See Zywicki, *Just-So Stories*, *supra* note 34.

<sup>82</sup> The average premium for a fixed-rate mortgage over an adjustable-rate mortgage is about 100 basis points. See *id.*

<sup>83</sup> See *id.*



biases.<sup>84</sup> It is also not difficult to provide after-the-fact explanations grounded in the *ad hoc* application of various cognitive biases to explain the choices that led to these mistakes, regardless of whether adjustable-rate or fixed-rate mortgages. If some homeowners select an adjustable-rate mortgage and interest rates increase then they could be said to have made errors of optimism, hyperbolic discounting, or some other bias that produced their error. If others select fixed-rate mortgages and interest rates fall, then this outcome could be attributed to biases such as status-quo bias or loss aversion. In short, any ex post outcome that turns out to be suboptimal for some consumers could be chalked up to behavioral biases. A theory malleable enough to explain both the overuse of adjustable-rate mortgages and the opposite is of limited usefulness as a foundation for understanding consumer demand.<sup>85</sup>

## **B. HOW DO BIASES MANIFEST THEMSELVES IN PARTICULAR CONTEXTS?**

A second theoretical problem for efforts to develop a robust and useful BE model of consumer finance and consumer financial protection is the difficulty of determining whether and which biases will apply in a particular choice context. Thus, the same bias might generate completely contradictory predictions depending on how the choice context is identified.

Consider the most prominent example of BE policy analysis—the argument that individuals save too little (i.e., undersave) for retirement relative to their supposed true preference to save more.<sup>86</sup> This failure to save as much as people say they want to do is supposed to be attributable to a variety of cognitive biases that are said to favor short-term consumption over long-term savings for retirement, including self-control problems, procrastination, and hyperbolic discounting.<sup>87</sup> Under the logic of this argument, the failure to save adequately can be assessed by the difference between the amount that people say they want to save and the amount they actually do save each month. This supposed difference between what people do and what they say they want to do leads to the policy idea that workers should be nudged or required to increase their retirement savings by being automatically enrolled in their company’s employer-provided retirement plan, which would increase the number of people participating in the plan.

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<sup>84</sup> See *id.* In fact, available evidence indicates that consumers generally choose between adjustable and fixed rate mortgages in a fashion consistent with the predictions of economic rationality, namely, those with shorter time horizons who plan to move within a few years tend to be more likely to choose adjustable-rate mortgages than those who are expecting to stay put for a longer time. with respect to the particular question of mortgage choice during the housing boom, the increasing market share between fixed and adjustable rate mortgages was explained by changes in the relative price differentials between the two products created by the Federal Reserve’s interest rate policies during that period. See Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, Mercatus Center Working Paper No. 09-35 (Sept. 2009).

<sup>85</sup> See Zywicki, *Just-So Stories*, *supra* note 34.

<sup>86</sup> See Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* 106-07 (2008).

<sup>87</sup> See discussion in Zywicki, *supra* note 40.

But comparison of what individuals do in real-world contexts with what they say they might prefer under unconstrained conditions is less than a meaningful test. Probably almost everyone would prefer to save more for retirement if it does not interfere with other goals. As will be discussed further in Chapter 12, evidence reveals that the vast majority of current and future retirees currently are saving enough or more than enough for retirement, especially once government benefits are taken into account.<sup>88</sup> Fewer retirees today are struggling financially than the general population and only a minority of current workers are potentially on course to retire with inadequate resources.

But even those now saving less than average might be doing so only temporarily in light of the dynamics of their financial life cycles, changes in the dynamics of work and retirement, and the availability of government social welfare benefits. Changes in savings behavior over time should be taken into account rather than just compared with surveys of some preferred but unconstrained behavior like preferring additional retirement saving now. For instance, saving by higher income Americans should be reevaluated to account for their changing work and retirement habits, especially the tendencies of higher-income individuals to work longer and beyond the traditional retirement age and to increase their pace of retirement savings after satisfying more urgent spending and savings priorities in their family-building years, such as saving for a home purchase and college for children. With respect to lower-income families, the progressive nature of the social security system means that lower-income families will receive a higher replacement percentage of their income in retirement than average, reducing their need for private savings. Also, unfortunately, lower-income workers tend to have shorter lifespans on average than higher-income workers, but this reduces their need for large private retirement savings. But is it possible to state without equivocation that BE theory predicts that people systematically will undersave for retirement, and could one confidently assume that pushing them or requiring them to save more today would make them better off?

But BE identifies other biases that might be equally relevant to savings decisions and would predict that people will oversave for retirement.<sup>89</sup> For example, one supposed manifestation of the “optimism” bias is that people hold unrealistically optimistic opinions about their chances to live a long life and underestimate their likelihood of premature death as a result of accident or disease.<sup>90</sup> For example, the average 30-year-old American faces a 15 percent to 20 percent

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<sup>88</sup> See Zywicki, *Save Too Little*, *supra* note 40.

<sup>89</sup> Zywicki, *supra* note 40; Zywicki, *Just-So Stories* *supra* note 34.

<sup>90</sup> Individuals also supposedly underestimate their probability of getting divorced in the future, which if known accurately would be likely to produce reduced savings and increased consumption during married life. See Zywicki, *Just-So*, *supra* note 34.

likelihood of dying before they reach age 70.<sup>91</sup> If the optimism bias is accurate, this suggests that some people are oversaving for retirement, regardless of responses to surveys about implicitly unconstrained situations, because they are overoptimistic about their expected probability of living to retirement age and therefore are unrealistically deferring income to enjoy in retirement, which some of them are unlikely to ever see.<sup>92</sup> Yet they bear the cost of this overoptimistic biased estimate of life expectancy if they have to forego current enjoyment today, either by working more or foregoing consumption, to shift income to a speculative future they will never achieve.

And the propensity to save is not randomly distributed in the population, just as life expectancy is not randomly distributed.<sup>93</sup> Savings and other financial habits are correlated with other behaviors that affect mortality, such as eating, sleeping, working, exercising, weight, and smoking habits.<sup>94</sup> Savings and other financial habits are correlated with other behaviors that impact mortality, such as eating, sleeping, working, exercise, weight, and smoking habits. In general, those who save less than average for retirement are also those who tend to live a lifestyle that is correlated with an increased risk of premature death, such as smoking, working in a dangerous occupation, or being overweight. By contrast, those with higher levels of income and education tend to both save and live longer than average. Thus, it appears that those who are saving more, less, or the average amounts may not be exhibiting biases but actually may be saving optimally given their expected life expectancies.<sup>95</sup> As a result, policies designed to induce a savings rate based on a measure of average life expectancy and average retirement financial needs could have the unintended consequence of displacing this more nuanced pattern of the relationship between savings behavior and life expectancy with a crude default rule that reduces the fit for either group.<sup>96</sup>

Moreover, a natural limitation of human experience is that people have difficulty accurately projecting what their lives will be like in retirement. Many people believe they will be healthier and more active when they retire than they actually will be, thus they may overestimate their

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<sup>91</sup> See Any Kiersz, *This Is When You're Going to Die*, Business Insider (Mar. 21, 2014), <http://www.businessinsider.com/social-security-life-table-charts-2014-3>.

<sup>92</sup> Zywicki, *supra* note 40.

<sup>93</sup> Zywicki, *supra* note 40.

<sup>94</sup> Zywicki, *supra* note 40 **Error! Bookmark not defined.**, at 912-13.

<sup>95</sup> See Zywicki, *supra* note 40.

<sup>96</sup> In addition, automatically enrolling workers in a retirement plan with a default contribution rate can increase contributions in the short-term from those contributing less than average but can also reduce the contribution rate of those who were previously saving more than average. See Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. Econ. 1149 (2001); see also Mario J. Rizzo and Glen Whitman, *Escaping Paternalism: Rationality, Behavioral Economics, and Public Policy* 303-06 (2020) (discussing studies).

expected spending on travel and other activities. They may also underestimate how much their living costs will decline in retirement by eliminating from their budget the costs associated with working full time (taxes, commuting, clothing, etc.), as well as replacement rates of consumer durable goods, such as automobiles, furniture, and appliances. Because they have more time available, most retirees also substitute home production for many services they purchased when they were working, such as food preparation, home cleaning, lawn care, and home repair services. As a result of these unanticipated reductions in spending, many retirees today actually build wealth in retirement instead of drawing it down.<sup>97</sup>

Overall, it simply is not possible for any economist to be confident that people will be made better off by shifting income from today to decades into the future without knowing their current and future budget constraints and uncertainties about their projected life expectancies. Because of inherent household budget constraints, increasing one's retirement savings now can only be funded by reallocating funds from their current allocation to fund future consumption.<sup>98</sup> There are costs to deferring income, and they include not only reducing current consumption, but also potentially giving up valuable household investment opportunities. Other sacrifices could include challenges in meeting the expenses associated with raising children, reducing saving for other purposes (such as an emergency reserve fund, a home purchase, or college savings), needing to work more to increase income at the expense of time for family and personal development (such as exercise or enjoyable hobbies); or to simultaneously save more for retirement while increasing usage of high-cost consumer credit to maintain one's preferred level of consumption. As noted above, surveys of those who are not saving for retirement indicate that only a trivial number fail to do so because of BE-style motivations, such as "not having taken the time to do it," as opposed to weightier concerns such as not being eligible, trying to make ends meet month to month, paying down consumer debt or student loans, or saving for some other priority such as a home or college education. Moreover, as noted, between one-fifth and one-sixth of working-age adults will not survive to retirement age to enjoy their deferred resources. Thus, although changing the default rule with respect to enrollment in retirement plans could increase the overall rate of retiring saving, which by itself is unclear, this effect cannot be assumed to increase overall welfare without also understanding the opportunity

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<sup>97</sup> See 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/S004727270800131>.

<sup>98</sup> See discussion in chapter 12; Zywicki, *supra* note 40.

cost associated with budget-constrained households reallocating those resources from some other, usually also high-valued, purpose.<sup>99</sup>

A second example of the theoretical limits of BLE and predicting how purported biases will manifest themselves in particular choice contexts relates to the question of whether merchants should be permitted to impose a surcharge fee on customers who want to pay using a payment card (debit, credit, or prepaid card) instead of simply being permitted to offer a discount for using other types of payment.<sup>100</sup> Federal law requires that merchants be permitted to offer a cash discount to consumers as part of their agreement with credit card issuers, although many states have banned surcharging of card transactions.<sup>101</sup> Merchants, however, have wanted to be allowed to impose a surcharge to recover the credit card merchant discount fees incurred when a consumer pays using a card.

A group of American self-styled behavioral economists supported the merchants demand to be allowed to surcharge payment-card transactions and not just to offer a discount, asserting that having the ability to impose surcharges would be more effective at redirecting consumers to use a noncard alternative. They argued that even though a surcharge and discount were mathematically equivalent, labeling the price differential a “surcharge” instead of a “discount” would psychologically frame the issue as a “loss” to the consumer. This framing supposedly would trigger certain behavioral biases such as loss aversion and the endowment effect that would persuade consumers to more readily try to avoid the penalty by switching to a different payment mechanism.<sup>102</sup> Permitting a cash discount, by contrast, was asserted to be less effective because it would frame the transaction as a “gain,” which supposedly would cause consumers to be less responsive to the fee. As a result, permitting surcharging was asserted to be more effective at deterring use of payment cards than discounting and thereby would increase overall consumer welfare by reducing merchant costs. The proponents of the argument offered no real-

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<sup>99</sup> An additional example is the idea of “cooling-off” periods, which give consumers an opportunity to make a purchase but then to rescind it within a specified time period. Some behavioral economists have argued that cooling off periods are useful for consumers to overcome certain biases, such as hyperbolic discounting or myopia. On the other hand, cooling-off periods could be argued to be ineffective because of biases such as the status quo bias or commitment bias. *See Beales, To BE, supra* note 23, at 361. Indeed, such remedies could even be argued to be counterproductive, if consumers are more likely to make a purchase than otherwise expected based on a belief that they can return it if they change their mind but have an unrealistic assessment of their likelihood of doing so.

<sup>100</sup> *See* Todd J. Zywicki, Geoffrey A. Manne, and Kristian Stout, Behavioral Economics Goes to Court: The Fundamental Flaws in the Behavioral Law & Economics Arguments Against No-Surcharge Laws, 82 Missouri L. Rev. 769 (2017).

<sup>101</sup> Agreements between payment card networks and merchants also historically banned surcharging but those provisions were removed pursuant to a litigation settlement.

<sup>102</sup> *See* discussion *id.*

world empirical support for their hypothesis (and the limited evidence that is available suggests the opposite).<sup>103</sup>

The *a priori* reasoning of the American BLE scholars was striking because another group of BLE analysts, this one in the United Kingdom's Office of Fair Trading (OFT), examined the same pricing practice of surcharging and reached the opposite conclusion with respect to the welfare consequences for consumers. According to the OFT, this marketing scheme of announcing a lower up-front price and then adding fees later in the transaction process—a practice known as “drip pricing”—is one of the most harmful pricing practices for consumer welfare, as consumers rarely change their mind about going through with the transaction once they have reached that point but instead simply go through with it and pay the higher price.<sup>104</sup> Of particular note, the OFT pointed to several of the same biases to criticize surcharging that the American BLE scholars pointed to in supporting surcharging, such as the endowment effect. In other words, applying BE concepts to the same transactional context—allowing merchants to impose surcharges on consumers for using payment cards to conduct a transaction—American and British experts in behavioral economics reached the opposite conclusions about the welfare consequences of that policy for consumers. Once again, BE theories can be invoked in support of permitting something and its opposite.

Additionally, the example of surcharging, like BLE proposals to increase savings by manipulating default rules, illustrates the potential for BLE-based policies to backfire and result in harm to consumers. As explained by Zywicki, Manne, and Stout, there is an alternative explanation for why merchants want to surcharge payment card transactions, instead of just offering cash discounts: Surcharging (but not discounting) enables merchants to extract wealth by imposing surcharges where consumers have a highly inelastic demand for using cards and so are unable to reasonably avoid the fee by switching to an alternative payment device. This includes such transactions purchasing airline tickets, other travel, hotel rooms, items over the internet, and sit-down restaurants, or where consumers are not repeat customers and thus can be fooled by the merchant's drip-pricing techniques of luring consumers with a lower posted price and imposing a higher price that includes the surcharge later.<sup>105</sup> In fact, reviewing the evidence from countries where surcharging has been permitted indicates that merchants do not impose surcharges uniformly across industries but are much more likely to impose surcharges on payment cards in markets where consumers have less ability to substitute to alternative types of payments, such as those mentioned. Moreover, where surcharging has been permitted,

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<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 834-40.

<sup>105</sup> See Zywicki, Manne, and Stout, *supra* note 100; see also Helene Bourguignon, Renato Gomes, and Jean Tirole, *Credit Surcharges and Cash Discounts: Simple Economics and Regulatory Lessons*, 10 *Competition Pol'y Int'l* 12, 20 (2014).

merchants universally surcharge well above any reasonable estimate of their actual costs of accepting cards, which strongly suggests that merchants use surcharges as a profit center to extract wealth from consumers, instead of merely to cover their costs or to try to redirect consumers to an alternative payment device. In fact, far from using surcharges as a vehicle to persuade consumers to substitute some other payment device, such as cash, surcharging is most prominent in transaction settings where consumers are least likely to be able to substitute to a noncard alternative.<sup>106</sup>

### **C. ABANDONING REVEALED PREFERENCE IN FAVOR OF TAUTOLOGICAL OR UNTESTABLE HYPOTHESES**

An additional problem with using BE as a foundation for consumer financial protection policy involves properly specifying testable hypotheses concerning the ability of BE to explain observed behavior and the welfare consequences of some of its policy recommendations. In some instances, this can collapse into tautological reasoning. If BE theorists propose a policy intervention (such as a “nudge”) that is supposed to correct a problematic consumer behavior but the behavior is not observed to change, the BLE theorist concludes that the bias or anomaly is just more rigid than originally thought.

This problem of untestable and potentially tautological hypotheses stems from abandoning a consumer’s revealed preferences as the benchmark for assessing consumer welfare. Once revealed preference is abandoned, the theorist drives a wedge between an individual’s preferences as shown by actual choices made subject to existing constraints and what the theorist posits to be the individual’s true preferences. As noted, preferences are inherently subjective and context dependent, such that an individual’s preferred choices might differ over time or depending on the constraints and opportunities presented at the moment of making a choice. As a result, the theorist faces the daunting task of trying to reconstruct what constitutes the individual’s true preferences in a choice context without referring to the consumer’s actual choices as their presumptively preferred choice.

Consider as an example, consumer usage of bank overdraft protection. Many commentators have expressed concerns that some consumers use overdraft protection “excessively,” leading them to pay what behavioral economists believe to be excessive fees from frequent use of the product. Exemplifying these concerns, in 2010 federal financial regulators enacted a rule that banks can assess a fee for clearing a payment using overdraft protection for an ATM or nonrecurring debit card transaction only if the consumer affirmatively “opts in” to authorize the use of the service in that context, as opposed to the prior regime that authorized the bank to

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<sup>106</sup> Id.

automatically enroll customers in overdraft protection for those transactions subject to the consumer “opting out.”

The policy was applauded initially by BLE scholars, who saw changing the default rule from opt out to opt in as a useful nudge to induce consumers, especially more frequent users, to reduce their use of overdraft protection by raising the costs of using overdraft.<sup>107</sup> According to some BLE theorists, overdraft protection for ATM and debit card transactions is used to “exploit consumer mistakes” and “provide[s] little social value.”<sup>108</sup> The primary intended beneficiaries of the new rule were those who used overdraft protection frequently, as it was assumed they would benefit the most from making it more difficult to access overdraft protection.

After the adoption of the rule, however, frequent overdraft users were substantially more likely to opt into the usage of overdraft protection than those who rarely or never used it. Moreover, the likelihood of opting in increased in a linear fashion from those who never used the service (and who rarely opted in) to those who used the service frequently (and who opted in at the highest rates). BLE theorists view this tendency of more frequent users to opt in after the rule change as confirming their prior assumptions about the irrationality of frequent overdraft users and their susceptibility to manipulation by financial institutions through aggressive sales techniques. They did not consider any alternative hypothesis that might be consistent with consumer rationality.

For BLE theorists, the finding that frequent users of overdraft protection were also those who were most likely to opt in after the rule change is itself evidence of the depth of irrationality and lack of self-control among some consumers and the need for heightened efforts to protect them from themselves and banks.<sup>109</sup> But the conclusion that the failure to respond to the nudge demonstrates the irrationality of the underlying behavior is tautological—the nonresponsiveness of some consumers to a policy that is supposedly there to protect them from their own irrationality cannot be offered as proof of that premise that they are irrational. Under the reasoning of BLE theorists, no response by consumers could disprove the hypothesis that frequent usage of overdraft is driven by consumer irrationality and biased decision making: If usage by frequent users declined after the rule change, that would confirm the hypothesis that consumers had been fooled into using overdraft protection irrationally and changing the default rule was sufficient to overcome their biases, but if usage among frequent users did not change substantially (which was what actually happened), that would prove instead that they were even

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<sup>107</sup> See Lauren Willis, *When Nudges Fail: Slippery Defaults*, 80 U. Chi. L. Rev. 1155 (2013); see also Ryan Bubb & Richard Pildes, *How Behavioral Economics Trims its Sails and Why*, 127 Harv. L. Rev. 61 (2014).

<sup>108</sup> Bubb & Pildes, *supra* note 107.

<sup>109</sup> See Todd Zywicki, *Behavioral Law and Economics and Bank Overdraft Protection*, The Volokh Conspiracy (Nov. 20, 2013), available in <http://volokh.com/2013/11/20/behavioral-law-economics-bank-overdraft-protection/>,



more biased and irrational than originally believed, and that more severe steps would need to be taken to protect them from themselves.

There is an alternative hypothesis that does not rest on tautological reasoning and a self-confirming hypothesis of consumer irrationality—those who were more likely to opt into overdraft protection after the rule change were those who find greater value in the product and were willing to go to the additional effort to opt in.<sup>110</sup> Standard economic theory holds that those who would be willing to do so would be those who have the strongest and most inelastic demand for the product. In fact, frequent users of bank overdraft protection say the reason they use the product because they have poor credit and limited choice due to lack of access to other, more desirable types of credit, such as credit cards.<sup>111</sup> For the average heavy user of overdraft protection, the next best alternative is usually a payday loan, which can be comparable in cost to the consumer but often less convenient to use. Given their limited choices among a set of unattractive and constrained options, those who had the strongest and most inelastic demand for overdraft protection would be predicted to be most likely to opt in.<sup>112</sup>

### 3. BE's Empirical Foundations as Applied to Consumer Finance

A third problem area for a BE-based consumer financial protection policy program is its poor success in finding empirical support for its hypotheses in real-world contexts outside the artificial laboratory environment. This failure of BE as an empirical research program is ironic in light of its central claim that it predicts observed behavior by consumers more accurately than does the rationality-based assumptions of the neoclassical model. Yet when BE's hypotheses are tested empirically, they typically fail when compared to the traditional model of consumer demand for financial services laid out in the first half of this chapter.

Usage of consumer credit provides a readily-available testing ground for the claims of BE theories versus neoclassical theories of consumer finance. As noted above, the predictions of BE and BLE theories differ from traditional theory in three dimensions. Both theories accept the reality that in a world of uncertainty combined with imperfect and costly information, consumers will make mistakes in their selection and usage of consumer credit products. But they differ in important ways.

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<sup>110</sup> *Id*

<sup>111</sup> See Robert L. Clarke and Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 Rev. of Banking and Fin. Law.235 (2013-14) (summarizing research); Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 69 Wash. & Lee L. Rev. 1141 (2012).

<sup>112</sup> See also Fumiko Hayashi and Emily Cuddy, *Recurrent Overdrafts: A Deliberate Decision by Some Prepaid Card Holders?*, Fed. Res. Bank of Kansas City Research Working Paper RWP 14-o8 (Oct. 2015).

The neoclassical model predicts: (1) Most consumers will choose correctly in the sense of making choices that increase their welfare and avoiding those that make them worse off, (2) errors will be systematically unbiased, and (3) consumers generally will learn from their mistakes over time, will take actions to change their future course of action in response to past mistakes, and their propensity to take corrective action will be related to the costliness of their mistake. The BE model, by contrast, predicts: (1) Most or a large number of consumers will make mistakes with respect to their choices, frequently making choices that result in reducing their welfare, (2) errors will be systematically biased, resulting in large welfare losses, and (3) because of the deep-seated and unconscious nature of many of their biases, consumers will be slow to learn from their mistakes and slow to change their behavior going forward to reduce those losses.

There are few papers that directly attempt to test BE hypotheses of consumer finance against predictions provided by the neoclassical model. Although many examples could be provided, two notable examples are briefly discussed here: credit card usage and payday loan usage. In both instances, the predictions of BE have been roundly rejected.

One of the most prominent applications of BLE has been to the analysis of credit card usage by consumers.<sup>113</sup> Law professor Oren Bar-Gill has argued that consumer usage of credit cards is explained by a variety of behavioral biases that lead consumers to overuse credit cards and to make expensive mistakes that reduce their economic welfare. Bar-Gill identifies the “underestimation” bias as a primary source of irrationality, exacerbated by problems of hyperbolic discounting. Bar-Gill claims that biases such as hyperbolic discounting and lack of self-control create a baseline problem where consumers are unable to govern their spending impulses, which are empowered by the ability to make purchases with their credit cards even without sufficient liquidity. He claims that consumers then justify these purchases by telling themselves that they will pay for those purchases at the end of the month when the bill comes due, but because of the “underestimation” bias, consumers are unrealistically optimistic in their ability to pay their credit card statement in full when due. This leads them to unexpectedly revolve their balance to the next month, at which time the dynamic repeats itself. Indeed, according to Bar-Gill, “credit card financing [is] *uniquely* vulnerable to the underestimation bias” compared with other types of consumer credit such as closed-end installment loans.<sup>114</sup>

According to Bar-Gill, these same biases to focus on short-term rewards at the expense of long-term costs also affect the shopping process for credit cards. In particular, the unrealistic beliefs of consumers that they will not revolve their credit card balances leads them to undervalue the

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<sup>113</sup> See Bar-Gill, *supra* note 46.

<sup>114</sup> Bar-Gill, *supra* note 46, at 1379.

importance of interest rates when they choose their credit card and to focus unduly on short-term features such as the annual fee, rewards, and short-term “teaser” rates. As a result, once consumers end up revolving their balances, they pay higher APRs and larger finance charges than they would have if they had instead shopped for their card based on a more realistic assessment of their probability of revolving their balances. Bar-Gill also proposes some ancillary hypotheses, such as the prediction that debit cards would never gain substantial market share in the United States because of the inability of debit card issuers to exploit consumer’s underestimation bias and the temptation of deferred payments.<sup>115</sup>

Summarizing his argument, Bar-Gill believes: (1) consumers frequently err in their usage of credit cards, specifically by underestimating their likelihood of revolving their balances from month to month, (2) consumer errors are systematically biased, in that consumers are much more likely to underestimate their likelihood of revolving their balances than to overestimate, and (3) consumers do not learn from their mistakes, and as a result continue to make the same mistakes repeatedly, leading to ever-growing mountains of debt and ever-higher finance charges until they finally collapse under the weight of their debt.

Bar-Gill did not attempt to provide much empirical support for his claims, but they were evaluated by Durkin, Elliehausen, and Zywicki.<sup>116</sup> Reviewing existing data and empirical studies, Durkin, et al., concluded that none of the hypotheses suggested by Bar-Gill’s arguments were confirmed empirically: (1) The majority of consumers accurately predict their likelihood of revolving their balances from month to month, and in selecting their credit card, those who expect to revolve their balances are more aware of their APR and more likely to change credit cards in response to an offer of a lower APR than those who do not revolve their balances; (2) any errors that consumers make with respect to their credit card choice and usage is unbiased, meaning that consumers are no more likely to underestimate their potential to revolve balances than they are to overestimate it; and (3) consumers who make mistakes with respect to credit card selection respond by adjusting their behavior going forward, and the larger the size and cost of their mistakes, the more likely they are to alter their future behavior.<sup>117</sup>

In addition, Durkin, et al., concluded that contrary to Bar-Gill’s prediction, debit cards would gain only “limited success vis-à-vis the credit card,” debit card usage surpassed credit card usage

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<sup>115</sup> *Id.* at 1378.

<sup>116</sup> 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 *Supreme Ct. Econ. Rev.* 1 (2015).

<sup>117</sup> See Sumit Agarwal, Souphala Chomsisengphet, Chunlin Liu, and Nicholas S. Souleles, *Do Consumers Choose the Right Credit Contracts*, 4 *The Rev. of Corp. Fin. Studs.* 239 (2015).

in transaction volume the next year.<sup>118</sup> Nor has there been evidence that credit card usage had created an upward spiral in household indebtedness over time leading to increased risk of financial breakdown. Consumers were also not found to be irrationally responsive to short-term product attributes such as credit card rewards or teaser rates.<sup>119</sup> In short, there appears to be little evidence to support the hypothesis that consumer credit card usage is better explained by BE or BLE theories of consumer demand than the traditional model.

Use of alternative financial products has also been the subject of BLE theorizing about consumer demand for financial products. Relying on many of the same purported biases as with credit cards, BLE theorists have argued that the initial decision to take out a payday loan and then to roll over the loan is motivated by behavioral biases such as optimism, imperfect self-control, status quo bias, and hyperbolic discounting.<sup>120</sup> Empirical studies by Ronald Mann<sup>121</sup> and Allcott, et al.,<sup>122</sup> test the hypothesis that payday-loan borrowers are systematically overoptimistic in their beliefs about their likelihood of rolling over their payday loans. Mann surveyed payday-loan customers about their expectations of how many periods it would take them to repay their loans and then compared their predictions with their actual performance. He found that a majority (60 percent) of customers correctly predicted at the time of their loan how long it would take to repay the loan, and that errors among those who did not accurately predict the time to repay were unbiased, meaning that payday-loan customers were just as likely to repay their loans earlier than expected as they were to repay their loans later than expected.

Using a similar methodology to Mann, Allcott, et al., found that “[O]n average, people almost fully anticipate their high likelihood of repeat borrowing.” They also found that payday-loan borrowers learned with experience, and although inexperienced borrowers did understate their expected course of borrowing, “more experienced borrowers predict exactly correctly on average.” Of additional note, Allcott, et al.,<sup>123</sup> compared the relative success of actual payday-loan borrowers at anticipating how long it would take to repay their loans with the predictions of

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<sup>118</sup> The 2010 Federal Reserve Payments Study, Noncash Payment Trends in the United States: 2006-2009 at 5, Exhibit 2 (Apr. 5, 2011). In 2006, 27% of noncash transactions were made by debit card and 23% by credit card. In 2003, 19% of noncash payments were made by debit and 23% by credit card. See the 2007 Federal Reserve Payments Study, Noncash Payment Trends in the United States: 2003-2006 at 5, Exhibit 2 (Dec. 10, 2007).

<sup>119</sup> See Howard Beales and Lacey L. Plache, *Rationality, Revolving, and Rewards: An Analysis of Revolving Behavior on New Credit Cards*, 21 S Ct Econ Rev 133 (2014); Tom Brown and Lacey Plache, *Paying with Plastic: Maybe Not so Crazy*, 73 U Chi L Rev 63 (2006).

<sup>120</sup> See T.R. Harmon-Kizer, *Let the Borrower Beware: Towards a Framework for Debiasing Rollover Behavior in the Payday Loan Industry*, 42 J. Consumer Policy 245 (2019).

<sup>121</sup> Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, 21 S. Ct. Econ. Rev. 105 (2014)

<sup>122</sup> Hunt Allcott, Joshua Kim, Dmitry Taubinsky, and Jonathan Zinman, *Are High-Interest Loans Predatory? Theory and Evidence from Payday Lending*, working paper (Mar. 9, 2020).

<sup>123</sup> See Allcott, et al., *supra* note 122.

a group of experts consisting of payday-lending practitioners and academic economists who study related issues. They found that while actual payday-loan borrowers underestimated their future borrowing by just 4 percentage points (all among less experienced borrowers) the group of “experts” predicted that payday-loan borrowers would underestimate their future borrowing by 30 percentage points. This suggests that experts hold a much dimmer view than is warranted of the ability of payday-loan customers to understand their needs and pursue available solutions. To the extent these experts’ views are representative of the views of regulators and other policymakers, their inaccurate stereotype of the low sophistication, rationality, and intelligence of payday-loan customers, could make those authorities overoptimistic about their ability to identify policies that will improve consumer welfare by overriding the choices of those they claim to be protecting

## 4. The supply of consumer credit

Chapter 2 of this report discussed how credit use, referred to today as “consumer credit,” has been widespread in the domestic population for at least a century and especially since World War II. Chapter 3 then examined how economic theory and evidence over this time shows that mainstream consumer-credit use does not demonstrate just profligacy or irrational short sightedness as some observers have on occasion believed. Rather, individuals employ credit for many reasons but most often for asset purchases or response to emergencies, providing a return over time together with useful change in timing of inflows and outflows. Credit use is influenced by life-cycle stage, where younger individuals and households are more likely to show credit demand than older ones.

The change in timing of spending allows individuals to undertake purchases of assets or alleviate costs of emergencies while using the goods or services purchased. This avoids paying for more costly substitutes or doing without for some period that could be lengthy and expensive. But none of the chapters so far has included discussion of the credit-generating process itself and how production costs influence the supply of consumer credit. Following the discussion in this chapter and in Chapter 5, Chapter 6 then looks in more detail at background and concepts of regulation and what regulation has meant for consumer protection in the credit area.

Concerning credit supply, it is easy enough to see at the outset that most consumer credit is not forthcoming either from family members or other individuals, although this sometimes happens. Rather, modern consumer credit is mostly sourced by financial institutions, but this is not the complete story either.

Banks and other financial institutions are not the ultimate suppliers of funds they lend. Instead, they function as “financial intermediaries” because the funds advanced to consumers are mostly not the institutions’ own. They obtain funds from savers, typically also individuals but also from other intermediaries that obtain funds directly from the ultimate savers. Financial institutions such as banks and credit unions but also many others pool the savings of millions of individuals and lend them productively to businesses, governments, and consumers. In fact, even if not widely understood among the public this way, those with the funds are lending their funds to the banks or other financial intermediaries that then pool the funds and lend them further to

businesses, governments, and other consumers. This process of lending by the intermediaries to ultimate borrowers generates the revenues for them to provide a return to ultimate funds providers. In the transfer process from ultimate savers to ultimate borrowers, the intermediaries provide a number of important services to be discussed here further.<sup>1</sup>

This chapter contains four sections: First, it focuses on where benefits arise in the funds-transfer process. It turns out that benefits accrue to both the funding and lending sides of the transfer. Second, the chapter turns to what produces costs, discussing more specifically what causes costs on the lending side.

The third section of the chapter concentrates on available empirical information on production costs of lending. It especially examines information about costs of producing small-dollar traditional installment loans from finance companies, an area where statistical information is available, but also on how these costs compare with other intermediaries. The fourth section focuses on how costs lead to charges to borrowers. Truth in Lending provides for disclosure of these charges in the form of consistently calculated finance charges and Annual Percentage Rates on many consumer credit transactions.

## 4.1 Financial Intermediation

Consumer credit provided by financial institutions, like any other good or service used by consumers is the end product of a production process. Producing consumer credit involves transfer of funds from savers who have them to borrowers who desire to use more resources now than they otherwise would have immediately available. As outlined in the previous chapter, borrowing provides current access to household goods and services that provide investment returns or alleviate costs due to emergencies. The important point is that borrowers can save for the purchases through loan repayments while using the goods and services, thereby avoiding doing without or paying for expensive alternatives during the saving period. As ultimate sources for the loans, credit users employ saved resources made available by individuals through financial intermediaries.

This raises the interesting question: Who are the savers providing the saved resources? Examining the Federal Reserve's "Financial Accounts of the United States" series shows that

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<sup>1</sup>For early discussion of the role of financial intermediation, see JOHN G. GURLEY AND EDWARD S. SHAW, *MONEY IN A THEORY OF FINANCE* (1960). There is lengthier discussion than here with more references about the financial intermediation process for consumer loans in THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI *CONSUMER CREDIT AND THE AMERICAN ECONOMY* (2014), Chapter 5, which a few parts of the following section of this chapter draw upon.

while some resources arise from business and government saving, the bulk of saved funds in the economy arise in the large household sector.

Household providers of funds make them available to financial institutions in a variety of ways. There is little doubt that individual providers of funds would rather do so through institutions than directly to individual borrowers. Funds provision through institutions includes consumer transaction accounts with banks and credit unions (checking and money-market accounts), time accounts (savings accounts and CDs), life insurance reserves with insurance companies, pension rights and other retirement assets with pension funds (including individual retirement accounts, or IRAs), direct securities purchases (stocks and bonds), and purchase of mutual fund shares. The Federal Reserve's "Financial Accounts of the United States" shows the household sector had supplied more than \$95 trillion to financial markets and institutions through ownership of financial assets as of the end of 2019, mostly through financial intermediaries.<sup>2</sup>

Some of the funds providers are wealthy individuals, but financial asset holding is much wider than just the wealthy. Often the ultimate lenders are the same individuals who are the ultimate borrowers, like the individual in Chapter 3 who borrowed \$35,000 on an auto or truck loan but who also had \$35,000 in a savings account or IRA, or in a 529 plan for college education of children. Much of the accumulated savings of the household sector, like retirement reserves, is held in much less liquid form than the consumer credit that households obtain from institutions as loans for purchases.

The most recent Survey of Consumer Finances shows that about 98 percent of households had some sort of transaction or savings account in 2019 (including some with prepaid debit cards or government benefit cards). Transactions and savings accounts are important sources of funds for lending by banks and credit unions. Other kinds of financial assets include certificates of deposit (CDs), held by 8 percent of households; savings bonds, by about 8 percent; directly held stocks, by 15 percent; investment funds (for example, mutual funds), by 9 percent; various kinds of retirement accounts, by 50 percent; and cash-value life insurance policies, by 19 percent, among other classes of financial assets. Mean and median holdings of financial assets among all households with financial assets were \$364,000 and \$25,700, respectively.<sup>3</sup>

Throughout the discussion of financial intermediation that follows, it is worth keeping in mind that the intermediation process must benefit both household-sector savers and borrowers if it is to exist as a method of transferring funds. Intermediation must benefit both sides of the transfer

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<sup>2</sup>See *Financial Accounts of the United States*, until recently called the *Flow of Funds Accounts*, available since 1946 and found in Federal Reserve quarterly statistical release Z1 (<https://www.federalreserve.gov/releases/z1/default.htm>).

<sup>3</sup>Neil Bhutta, et al., *Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances*, FEDERAL RESERVE BULLETIN, p. 16 (September, 2020).



process by providing better risk-adjusted returns on savings (including safekeeping and accounting services) and reduced costs for borrowers, or the transfer process would not take place or would flow through other channels not involving intermediaries.

In theory, households could bypass financial intermediaries and make loans directly to other consumers (through platform lenders or not) to purchase houses, cars, or other goods. Peer-to-peer lending does exactly this. But very few households have the resources, acumen, or desire to provide the services of transferring funds from savers to borrowers. Typically, the funds used in loans are much different in form and amount than the funds acquisitions. Loans require underwriting, monitoring, collecting, and bearing default risks. As a result, most individuals prefer to lend money to a bank or other financial intermediary, which does have the expertise and resources to bear these costs and risks. In turn, the institutions pay interest and provide other returns on the accounts of these consumers to compensate them for their funds.

From time to time through the history of modern consumer credit, entrepreneurs or policy commentators have suggested a preference for direct person-to-person or peer-to-peer (PTP) lending, avoiding intermediaries. Recent examples include internet lending platforms such as Lending Club that bring funds sources (investors) together with borrowers for a fee of some kind. So far, however, it seems that such lenders are unlikely to replace large-scale financial intermediation due to the services that intermediation provides, unless the cost of providing intermediation services are too high for the revenues generated. Nearly all consumer lending takes place through intermediaries. On account of the importance of these intermediation services, including account and risk management discussed further below, active PTP lenders may well evolve into intermediaries and some appear headed in that direction. Indeed, several prominent online platforms that started out as PTP lenders have transitioned to offering loans in partnership with a traditional financial intermediary.

It is often not appreciated that this process of pooling consumer savings by financial institutions to put it to work as investment capital is particularly valuable to low-income consumers. Wealthier consumers could, again in theory, engage in peer-to-peer lending more easily, or invest significantly in direct financial assets such as stocks and bonds to earn a return. Lower-income consumers, by contrast, typically are less likely to use those investment products. Moreover, returns to them from depository institutions like banks and credit unions in the form of ready funds-transfer services and safety through FDIC insurance can be very important.

These useful services are available even in times like the present when interest paid on deposits is low.<sup>4</sup>

Overall benefits of intermediation for savers that almost seem obvious upon reflection are worth considering further. Financial intermediation provides returns to savers of a variety of sorts, some implicit to the point of sometimes being overlooked and others more explicit.

Among the implicit returns to savers is one already mentioned, the ready transferability of funds, often immediately for transactions accounts. Customer-directed transfers can take place through a nationwide and worldwide payments system using checks, debit and credit cards, and automated clearing house (ACH) transfers. Another is safety, including FDIC insurance for bank deposits and required public disclosures and fiduciary requirements for other institutions. There also are such important conveniences for consumers as instantaneous record keeping and annual preparation of necessary tax statements.

Returns are often more explicit on some financial assets, like interest on CDs or bonds that financial institutions issue, but there are also more kinds of less visible explicit returns. For instance, insurance companies use funds from policy premiums for investments that lower the overall insurance premiums for the insurance coverage. Likewise, anyone fortunate to have a defined-benefit pension receives a return from the investments of the pension fund. Such returns are even more readily visible for pension funds in the form of 401(k) plans and IRAs. Individuals with these plans typically count on the long-term investment returns of the plans to provide for their retirement years.

It is possible for individuals to manage their saved resources themselves, but many prefer professional management. The very wealthy may be able to manage financial assets well due to their experience, or they can hire financial managers. These possibilities are less probable for middle-class households and especially for lower-income families. These households are especially likely to find professional management services provided by financial institutions useful. As indicated, individuals could pool savings and find borrowers to provide a return on these savings without intermediation by financial institutions, but evidence and even imagination describes many instances where this could be intolerably risky for individuals, especially lower-income households without much margin to spare.

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<sup>4</sup>An analysis of one community bank found that 83 percent of the dollar balances in the bank's checking account were held by just 15 percent of the bank's customers, yet those with higher balances were paid only marginally higher rates of interest, if any, compared to those with much lower balances. See G. Michael Flores and Todd J. Zywicki, *Commentary on CFPB Report: Data Point: Checking Account Overdraft*, GEORGE MASON UNIVERSITY LAW AND ECONOMICS RESEARCH PAPER SERIES, No. 14-45 (July 16, 2016), available in [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2499716](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2499716).

In providing their services, financial institutions produce distinct financial products for market participants: savers, borrowers, or both. For example, banks and credit unions produce products for both savers (in the form of deposit products checking accounts, interest-earning savings accounts, and CDs) and for borrowers (loans). Because they provide financial products for both end points in the transfer process, banks and credit unions consequently are able to fund much of their lending with “internal funding” from their own products on the deposits side. It should be clear enough that the frequently used term “internal funding” is a bit of a misnomer, however, since the funds actually are borrowed externally from customers in the form of deposit products. They just often pass from ultimate source to use internally within the same institution.

Other intermediaries may focus more on one side of the process or the other, at least in terms of numbers of customers. For instance, consumer-oriented finance companies provide mostly lending products. They rely on obtaining funds for lending to their customers from other intermediaries, such as life insurance companies and pension funds.

These funding sources for finance companies are the ones that obtain the funds from households. Life insurance companies gather premiums from many policy holders and often lend the proceeds to other intermediaries in financial markets, including consumer finance companies that lend directly to individuals. Pension funds that obtain retirement savings from individuals or their employers also lend to other lenders such as consumer finance companies. Thus, there may be more than one intermediary between savers and borrowers, in this example insurance companies or pension funds lending to finance companies that lend to consumer borrowers. In this example, intermediaries provide services for other intermediaries involved in the process of transferring funds from ultimate savers to borrowers.

All of this involves expenses. Even “internal funding” by banks and credit unions is not without expense, of course. Although interest rates that depository institutions pay depositors currently are not very high, depositories still must maintain expensive operating and accounting systems to acquire and manage these funds. This may sometimes entail expensive branch systems with personnel costs, and accounting, control, and regulatory costs. Then there also are the actual lending costs for these institutions. They include establishing and maintaining branches, credit card systems, and other lending channels, as well as regulatory costs there too.

Institutions with presence primarily only on one side of the transfer or the other, like life insurance companies and pension funds on the savings side and consumer finance companies on the lending side, still have expenses associated with producing these products. At a minimum, all financial institutions have expenses associated with funds acquisition, recording, protection, and management. As lenders, there also are costs of lending and risk, and there are regulatory costs on both sides.

## 4.2 Costs of Lending

It quickly becomes clear enough that all intermediaries must contend with the costs of undertaking their businesses. It is also worth remembering that through economies of scale and specialization, financial intermediaries are able to perform the functions of funds transfer from savers to borrowers in financial markets at a lower cost than individuals could do on their own.<sup>5</sup>

This highlights an important point of the previous section that is worth emphasizing again: The transfer of funds is not from financial institutions' functioning as "them" to "us," but rather from individual consumers who have resources to those who need them, benefitting both sides of the transfer. Consequently, both sides benefit when the transfer is made as efficiently as possible, that is with the least possible cost caused by the transfer itself. Competition is an important element in enhancing efficiency and minimizing unnecessary private transfer costs, and so is efficiency in regulation. Inefficient, or unnecessary, funding and lending procedures and/or regulations do not benefit either side.

What then, more specifically, are the services that intermediaries provide on the lending side that produce costs, services that ultimate providers of funds do not typically want to provide themselves? More specifically than discussed above, they are: (1) information processing and underwriting, (2) risk intermediation, (3) monitoring, (4) temporal intermediation, and (5) size intermediation. Consider each of these in turn.

### 4.2.1 Information processing and underwriting.

This need arises from the uncertain performance of prospective borrowers who may in the future be unable (or unwilling) to pay as agreed. This possibility requires the lending institution to collect and evaluate information that provides a prediction on the likelihood that the borrower will repay so that the lending institution will be able to repay its own funds providers.

The information typically includes evidence of the borrower's ability to repay, such as the adequacy and stability of current and future income, assets, and other debts. It may also include evidence of the borrower's performance on previous loans from the same or other lenders. By collecting and evaluating information from many past experiences, financial intermediaries are able to develop expertise and even sophisticated statistical systems for predicting prospective borrowers' likely behavior, a process generally referred to as credit underwriting.

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<sup>5</sup>See George J. Benston and Clifford W. Smith, A Transactions Cost Approach to the Theory of Financial Intermediation, *JOURNAL OF FINANCE* (May 1976).

There is no doubt that financial intermediaries know much more about underwriting and how to lend than typical individual consumers who have resources available to lend. Most consumers would rather place their available cash or retirement reserves in a financial institution with information systems than lend the funds directly to other consumers themselves. There also can be no doubt that lenders have consistently attempted to bring cost-reducing technology to bear on this business problem, leading to electronic and even automated or semi-automated systems for information generation and credit evaluation when possible.

## 4.2.2 Risk intermediation

This service arises from the ability of lenders to make many loans and diversify across many borrowers and different types of borrowers. Very few, if any, government, business, or individual borrowers are able to borrow without exposing a lender to some risk of default. Regardless of income, wealth, or assets pledged as collateral, any consumer borrower may have difficulty repaying debt as a result of a loss or reduction in income, sickness, accident, divorce, pandemic, legal judgment, or some other hardship. But if the risks arising from such hardships are not highly correlated across individual consumers, a lender can reduce risk by simultaneously lending to many consumers. Harry Markowitz showed that for any given expected return, diversification can reduce risk in a portfolio of securities if returns are not perfectly correlated.<sup>6</sup> With others, he received the Nobel Prize in economics for developing his important early insights in this area. This general concept is now discussed in every textbook on financial markets. Unfortunately, intermediation of risks does not imply elimination of losses. Losses due to unforeseen contingencies are going to arise regardless of quality of the underwriting. Spreading of risks by intermediaries that make many loans works to keep them under control and manageable.

## 4.2.3 Monitoring

Along with underwriting and risk spreading, lenders also monitor borrowers' performance in order to manage risk. In consumer lending, the payment process provides the primary means for monitoring. Consumer loans typically require periodic payments of interest and principle. In closed-end (that is, fixed-contract) loans, the payments are usually regular periodic amounts for a fixed length of time, which fully amortize the loan. In open-end loans (revolving credit like credit cards), the payments may be largely at the borrower's discretion, with only a minimum amount being required but still some amount.

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<sup>6</sup>Harry Markowitz, *Portfolio Selection*, JOURNAL OF FINANCE (March 1952).

In either case, timely payments provide evidence of the borrower's continued ability and willingness to repay. Late payments are an indicator that a problem may have arisen. Specific charges imposed for late payments are an attempt to discourage such behavior (and not only for the purposes of increasing revenue as sometimes believed, although late fees may help cover costs associated with late payments as well as discouraging them). Lenders also attempt to contact borrowers who are late to seek resumption of payments and assess likelihood of future repayment problems. If the problems are serious, a lender may arrange for workout or a resolution. When a resolution is not feasible, a lender may liquidate or foreclose on collateral, if available. A lender may also obtain periodic credit reports from a credit reporting agency, popularly known as a "credit bureau," to monitor the borrower's behavior and prospects.

For example, installment loans like auto or cash loans create a long-term obligation to be paid in monthly installments for an established period of time. Under the loan payment schedule, if the borrower makes all the payments on time for the scheduled duration of the loan, the loan will be amortized and paid in full. Of course, simply establishing a payment schedule that will amortize the loan does not mean that the borrower will actually adhere to that schedule, making monitoring a requirement.

Sometimes there are more costs. For instance, sometimes borrowers will be unable or unwilling to make one or more payments. This will require the lender to try to contact the borrower to try to collect the payment or to negotiate for an extension or reworking the loan. This can be a labor-intensive and expensive process, sometimes requiring employees to make repeated telephone calls to reach and negotiate with a delinquent debtor. Each of these contacts takes time and effort that increases the costs of monitoring and servicing loans.

Credit bureaus may mitigate such costs to some degree, but they do not solve them. In a conference presentation at the Federal Reserve Bank of Philadelphia, businessman Gary Phillips discussed costs at one of the larger remaining traditional installment small-loan lenders (not to be confused with a payday lender). He noted that while credit bureau scores are important, an employee's judgmental analysis is a critical input in underwriting low credit-score applications. Employees must assess the applicant's ability to pay and determine a set of loan terms (loan amount and monthly payment) that an applicant can easily afford to repay.

Further, sometimes low-score or even higher-score borrowers who are on a self-amortizing installment-loan schedule that pays in full at a specific maturity do not necessarily remain on schedule without reminders. This process is costly because it is especially labor intensive. Despite efforts by lenders of this kind to make monthly payments easily affordable, a significant share of borrowers makes late payments. Employees spend considerable time monitoring and attempting to contact delinquent borrowers, making arrangements for payment, and resolving problems. Phillips also provided break-even APRs for different loan sizes based on the company's costs that take all this into account. His data showed an inverse relationship between

necessary APR and loan size, and the levels of APR at each loan size were broadly consistent with the National Commission on Consumer Finance's (NCCF's) estimates in 1972.<sup>7</sup>

From this discussion, it is easy enough to see the underlying cause of the inverse statistical relationship: First, costs of functions like information processing and much of the monitoring function through taking payments are relatively similar for small loans and larger ones. Therefore, they are relatively more per loan dollar for the smaller loans. Then, labor-intensive actions involving reminders, collecting loans, and bad debts likely are going to be higher for smaller loans, due to riskier borrowers. As indicated, the NCCF also found this inverse relationship between loan costs per loan dollar and size of loans, and it is discussed further later.

#### 4.2.4 Temporal intermediation

This function arises from frequent preference of individual borrowers for different terms to maturity than savers. Borrowers financing the purchase of expensive consumer durable goods or housing purchases, for example, may prefer a relatively long term to maturity, which produces smaller monthly payments. On automobile loans, this consideration can lead many borrowers to choose terms to maturity of five years or even longer. Housing loans can extend for 30 years.

But many savers prefer a shorter term to maturity for their savings than borrowers prefer, or even immediate access to their savings. Intermediaries can change maturities, even using transactions account payable immediately as funding for mortgage loans extending for 30 years. Firms and consumers want a place to keep temporary surpluses until they are needed for payments or until sufficient funds are accumulated for investment. Consumers may also prefer a short term to maturity or immediate access for precautionary reserves held for emergencies. In contrast, pension rights, life insurance reserves, and IRA assets may have maturities much longer than consumer loans.

Individual savers do not normally withdraw all savings simultaneously; however, nor do they all add to their savings at the same time. Pooling the savings of many savers enables financial intermediaries to maintain sufficient funds to lend on a longer-term basis while satisfying the needs of individual savers to withdraw savings on short notice.<sup>8</sup> Financial intermediaries also

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<sup>7</sup>Presentation by Gary Phillips to the Federal Reserve Bank of Philadelphia Consumer Finance Institute (2013). Accessed at <https://www.philadelphiafed.org/-/media/consumer-finance-institute/payment-cards-center/events/conferences/2013/small-dollar-credit/papers/phillips.pdf?la=en>

<sup>8</sup>Recognition of this concept led to the beginning of deposit banking in England in the seventeenth century. At that time, people deposited gold at London goldsmiths for safekeeping. Goldsmiths soon came to realize that they did not need to hold the entire amount of deposited gold to redeem deposits and began to lend part of the deposited gold. Thus, goldsmiths became financial intermediaries. Furthermore, goldsmiths functioned essentially as banks when

normally are able to anticipate the need for funds to cover withdrawals, and they may raise additional funds to meet needs in wholesale money markets.<sup>9</sup>

## 4.2.5 Size intermediation

This refers to how financial intermediaries can raise funds in small or large amounts but then lend them in the opposite size extreme. For instance, banks commonly acquire small amounts of funds from savings or checking accounts and then lend them as larger automobile, mortgage, and business loans. Some financial institutions may also raise large amounts of funds at one time in capital markets to make small loans, such as finance companies that raise large amounts in national or international bond and commercial paper markets to fund smaller loans to consumers and businesses. Much of this funding comes from other intermediaries like life insurance companies and pension funds. Individuals lending to one another are not likely going to be able to undertake these activities for themselves, or want to undertake them, and this encourages the growth of intermediaries to provide them and facilitate the flows of funds from savers to borrowers.

But intermediation is not free, and there are personnel, systems, risk, and regulatory costs associated with providing the services of financial intermediation. As indicated, costs arise in various ways in the intermediation process outlined above, and different institutions use different approaches to mitigate them and run their businesses.

For example, commercial banks incur costs from their extensive infrastructure used both for acquiring funds through deposits, often of small amounts, and distributing the funds by making loans typically in larger sizes. In recent decades, they have acquired funds and loans through branching systems, but they also have moved to reduce costs where possible by substituting

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goldsmiths' receipts became accepted as a means of payment as well as than the gold itself, because the receipts were more convenient to exchange than the deposited gold. For further historical discussion, see W. T. NEWLYN, *THEORY OF MONEY* (1962).

<sup>9</sup>Occasionally financial intermediaries experience sudden unexpected large withdrawals because of concerns about an intermediary's own solvency, concerns about solvency of other similar intermediaries, or changes in macroeconomic conditions which shift savers' preferences among savings instruments. Financial intermediaries that raise large shares of funds from short term savings instruments, especially accounts like transaction/checking accounts that can be withdrawn on demand, are potentially vulnerable to such events. Today, central banks like the Federal Reserve System and guarantee agencies like the FDIC mitigate such problems, as seen recently in both 2009 and 2020. Concerns about the solvency of a particular bank, or the banking system as a whole, have caused bank runs in the past, a large part of the reasoning behind establishing the central bank and federal deposit insurance in the United States.

Increases in the level of market interest rates have also sometimes caused savers to withdraw funds from banks and savings institutions more gradually and shift them to direct US Treasury securities, a process called "disintermediation." Such disintermediation occurred from time to time during the period from 1936 to 1986 during periods of high interest rates. At the time, interest-rate ceilings on deposits (called Regulation Q) prevented depositories from raising rates as market rates rose. After this time, removal of interest rate ceilings on consumer deposit accounts dramatically reduced the incidence of disintermediation.



electronic access for branches and branch personnel. Historically for business reasons, and more recently also due to regulation, banks have tended toward the lower end of the lending-risk scale. Lower risk, together with larger loans, has tended to place these institutions among the lower-cost providers of consumer credit. As discussed in Chapter 3, theorists/empiricists Juster and Shay included them among those they referred to as “primary lenders.”<sup>10</sup>

In contrast, consumer-oriented finance companies have used a different business approach. Precluded in most places from taking deposits from the public, finance companies have acquired most of their funding for lending from other intermediaries including banks, insurance companies, pension providers, mutual funds, and other institutional lenders in national and international capital markets. Many of them are publicly held stock companies that raise capital through issuing equity shares. Others are funded by private investment, such as FinTech companies funded by venture capital investment, at least initially. This has made funds acquisition for them considerably less labor and infrastructure intensive than for banks, lowering their costs on this side of the intermediation process.

But their operations in riskier parts of the lending markets have tended to raise their costs of monitoring and credit losses relative to banks. They have often made smaller loans on average than banks, tending to raise operating costs per loan dollar (mentioned above and discussed further later). They also typically have operated at lower “leverage” ratios than banks. This means they usually have a lower proportion of market borrowing compared with ownership capital than banks, and this could lower their return on equity capital relative to banks, other things equal.<sup>11</sup> Consumer finance companies often are in the range of “secondary lenders” discussed by Juster and Shay.

As this quick examination shows, costs on the lending side of financial intermediation arise from a number of groups of cost-causing activities necessary at this end of the financial intermediation process. Different institutions face these challenges in different ways, leading to different kinds of institutions.

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<sup>10</sup> F. THOMAS JUSTER AND ROBERT P. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION (1964).

<sup>11</sup>Capital-market lenders to them have forced this lower-leverage approach (lower proportion of borrowed funds) due to their higher risk in the absence of FDIC insurance on the capital-market funds. Other things equal, this would mean higher funding costs and lower profitability for finance companies for the same revenue and other costs. But “other things equal” is a very large theoretical issue for the importance of financial structure on profitability, even aside from the requirement of same revenue and other costs for full and proper comparison, but there is no need to go further into this question here. The financial structure issue involves the general theoretical area known as the “Modigliani-Miller Theorem,” a highly technical and mathematical area of financial economics. Professors Franco Modigliani (Massachusetts Institute of Technology) and Merton Miller (University of Chicago) received the Nobel Prize in economics in different years for a variety of contributions to financial economics, including this early joint work at Carnegie Mellon University.

Continuing to become more specific as this narrative proceeds, it is common to classify lending costs into two groups for further analytical purposes: operating costs and non-operating costs, each with subcomponents. The categories and subcomponents seem obvious upon reflection, and they differ across classes of institutions due to the nature of their businesses. Recognition of kinds of lending costs is very old.<sup>12</sup>

## Operating Costs

Operating expenses include costs of originating loans, processing payments, collection of delinquent accounts, and bad debt expenses. Non-operating expenses include taxes, interest expense arising in funds-borrowing activities, and a return on the owners' equity share of the advance to the borrower. Although economic theory, as well as experience, suggests that intermediation lowers the overall cost of the transfer of resources from ultimate savers to borrowers, it is still true that the prices charged for loans must fully cover operating and non-operating costs of the transfer process. Otherwise, the institution cannot remain in business and provide the services of intermediation.

To originate a loan, a lender must solicit customers through advertising or lead generation, take applications, verify and evaluate information in applications to determine whether to grant credit and how much credit to grant, manage aspects of any collateral, prepare documents, disperse the funds, take in and account properly for payments, and comply with regulations. Many of these activities can be labor intensive, and some often require branch locations for certain kinds of credit. The number of branches and their operating hours vary according to the characteristics of the customer base.<sup>13</sup> In addition, all the lending and collecting activities must be done in compliance with a variety of sometimes complicated legal requirements, costs of which do not always fall with equal relative weight on all institutions.

Loan approval rates vary by industry, yet each application must be subject to at least some initial scrutiny, and oftentimes extensive scrutiny, before a final determination whether to extend

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<sup>12</sup>For instance, economists have long recognized that lending costs involve more than just return for payment later (interest or the time value of money) and risk. *See, for example, IRVING FISHER, THE RATE OF INTEREST: ITS NATURE, DETERMINATION, AND RELATION TO ECONOMIC PHENOMENA* 88, 209 (1907)); ALFRED MARSHALL, *PRINCIPLES OF ECONOMICS* 8<sup>TH</sup> ED. 488-9 (1920); and EUGEN VON BÖHM-BAWERK, *CAPITAL AND INTEREST, A CRITICAL HISTORY OF ECONOMICAL THEORY* 7 (1922). In their *History of Consumer Credit*, Gelpi and Julien-Labruyere trace this understanding to the middle ages where medieval religious scholastics allowed for interest in four cases: *lucrum cessans* (deprivation of the advantages of a different advantageous investment (forbearance)), *damnum emergens* (suffering damages due to risk such as late payment), *stipendium laboris* (operating costs), and *ratio incertitudinis* (other risk costs). *See ROSA-MARIA GELPI AND FRANCOIS JULIEN-LABRUYERE, THE HISTORY OF CONSUMER CREDIT*, 37 (2000).

<sup>13</sup>For example, surveys of payday loan borrowers reveal that store outlets are plentiful in many places because many potential customers have limited transportation (for instance, they may live in cities and not own a car). Also, some customers value longer hours than available at banks or credit unions because many of them are hourly shift workers who are unable to visit financial institutions during normal business hours.

credit is made. Because the norm in most consumer finance industries is not to charge an application fee, this means that the costs of processing applications for those who eventually are declined must be covered by those whose loans are approved. This cross-subsidization is analogous to the truism that losses on loans that default must be recouped in the prices charged to those whose loans are paid. As indicated, all this must be done in compliance with a variety of sometimes complicated and costly legal requirements.

After origination, further operating costs are associated with consumer lending. Closed-end credit is typically repaid in regular installments, which involve the processing of a series of payments over the term of the loan and entail recordkeeping. In some cases, payments are made electronically, either through a preauthorized debit to the consumer's deposit account or by the customer through the internet, but many payments continue to be made by check. In either case, repayments involve specialized equipment and/or employees. Electronic and internet systems require computers, software, and operators. There also are call centers or other operating systems to handle questions, problems, and disputes.

Open-end credit involves multiple extensions of credit and repayments. As most open-end accounts involve frequent, relatively small extensions of credit, processing is highly automated. Nevertheless, employees perform several processing activities, and the necessarily extensive processing and communications systems are costly ongoing, requiring large data centers. Lenders typically have systems to authorize and process credit extensions automatically, although sometimes an employee may authorize an extension that exceeds a borrower's credit limit or an increase in the credit limit. Lenders monitor open-end extensions for fraud using automated systems, but fraudulent extensions are often detected by the borrowers when they receive their periodic statements. In these cases, employees in call centers record, evaluate, investigate, and act upon the information as needed, but the call centers are expensive to operate. Payments may be processed electronically, but many payments on open-end accounts are made by check and even automated equipment must be supervised by employees. Employees also process account status and billing questions; replacements for lost, stolen, or damaged cards; name and address changes; and requests for account closings and responsibility changes due to divorce or death.

An important characteristic of these underwriting and processing activities is that they occur because an application is taken and a loan made and, other things equal, they are unlikely to vary a great deal by the amount of credit involved. As a practical matter, they approximate fixed costs per loan.

For instance, costs of making a \$50,000 loan undoubtedly are higher than making a \$1,000 loan, but they are not going to be anywhere near 50 times as much. The operating costs associated with compensating employees for their time taken in underwriting and for rent, utility payments, making a phone call to a delinquent customer, or some machine or employee

opening the mail and entering the amount on the check into the computer under the customer's account do not depend upon loan amount. They are all essentially fixed costs that either do not vary with the number of loans made, or variable costs that do not scale proportionally to the size of the loan. This characteristic is also present in other activities, like accounting and record keeping, which give rise to operating costs. Many legal costs that arise from compliance with regulatory requirements are especially likely to have such characteristics.

Further considering costs by loan size, the costs associated with making a smaller loan can even be more expensive in absolute terms and not just relative terms, when compared with larger loans of different types. For example, auto loans made to low-risk borrowers to finance new cars will require some initial costs in loan origination. Many of those costs will be standardized, routine, and automated, all of which reduces the costs of making that loan. And after the loan is originated, it may require relatively little in ongoing servicing costs, especially if the borrower pays each month through an ACH or other electronic transactions.

By contrast, auto loans made to higher-risk borrowers to finance less expensive used cars will often involve more heterogeneous borrowers and collateral. The borrowers can have more idiosyncratic credit characteristics. Loan approval rates might actually be lower in these cases than for larger auto loans to prime borrowers. Customers might be more likely to pay by check or even in cash instead of electronic transfer, incurring costs associated with opening and processing the payment. More important, these loans to higher-risk borrowers will, on average, require more ongoing monitoring and collection activities, as employees exert time and effort to contact delinquent borrowers and initiate collection or loan modification processes, all of which involve costs. Finally, loss rates may be higher, costs which must be spread as part of the costs of other loans. All this suggests smaller loans might actually produce higher absolute costs per loan made than larger loans, not just relative costs per loan dollar.

Consequently, the portion of the finance charge just to cover operating and processing expenses on a large loan is likely to be less relative to the loan amount than on a smaller loan, possibly much less. This means, in turn, that Annual Percentage Rate (APR) of charge is going to be less on a larger loan than on a smaller one to cover these costs, other things equal. This is explored further later in the chapter.

In addition, as indicated, some borrowers do not always make timely payments, and this varies by sector of the lending industry. A lender must monitor loans for late or delinquent payments. While identification of delinquent accounts and initial contact with the borrower may be automated, an employee may eventually have to contact a delinquent borrower to seek payment. Depending on circumstances, the employee may remind the borrower of an overdue payment, make repeated contacts to receive payment, negotiate a new schedule for repayment, or decide to turn a delinquent account over for more serious collection efforts like lawsuits. Employees must document promises to pay, payment plans, and accountholder actions or circumstances

relating to the delinquency. Employees may decide to pursue legal remedies such as recovering and selling assets taken as collateral. While some accounts with late payments and delinquencies may eventually be paid in full, processing such accounts can be quite costly. Other accounts are eventually charged off. For many lenders, losses due to charge-offs are a significant operating cost of lending. These costs all tend to be higher per loan dollar on smaller loans than on larger loans.

Losses on loans that do not repay are a concern to all lenders and can be a significant part of operating costs for some of them, especially those lending in subprime sectors of the lending markets. Losses tend to be quite low for mortgage lenders lending to prime risks, which is due at least in part to the intensive (and costly) underwriting procedures of mortgage lenders to differentiate among risk cohorts. The Federal Reserve statistical series shows very low loss rates on mortgage loans at banking institutions recently, but loss rates had reached nearly 3 percent in late 2009.<sup>14</sup>

Consumer-lending loss rates tend to be higher than bank mortgage lending, depending on the type of institution and its market sector, type of loan, and overall macroeconomic conditions. For instance, loss rates on consumer loans at banks were 1 percent in the fourth quarter of 2019, down from more than 3 percent in 2009 as a result of the Great Recession at that time. The rate of bank losses on unsecured credit card accounts stood at 3.65 percent in the fourth quarter of 2019 and over 4 percent six months later. In 2009, loss rates on credit card accounts had exceeded 10 percent and reached 11 percent in early 2010. Loss rates on small consumer cash loans at finance companies also were high and are discussed in more detail in the next section of this chapter after first looking briefly at non-operating kinds of costs for lenders.

## Non-operating Costs

Non-operating costs consist of cost of borrowed funds, income taxes, and return to equity funds. As discussed, much of the funding for consumer lending consists of borrowed funds, and the sources of borrowed funds also vary by the type of lender. Banks obtain by far most of their borrowed funds from customers' deposits. Because of deposit insurance, most deposits are risk-free to the depositor, and consequently are a low-cost source of funds. Banks also borrow funds at market rates in capital markets. Finance companies obtain borrowed funds from banks, the commercial paper market, and the long-term capital market where lenders include other institutions like life insurance companies and pension funds. The capital market is the largest source of borrowed funds for finance companies.

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<sup>14</sup>See Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," quarterly statistical release. Available at <https://www.federalreserve.gov/releases/chargeoff/>.

Significantly, the cost of borrowed funds per loan dollar is going to vary much less by loan size for a given lender than operating costs. When acquiring funds for lending, the first dollar acquired carries much the same interest charge as the ten-millionth dollar acquired or the billionth dollar, up to the ability of the lending company to acquire funds at all. This means that total costs still continue to loom larger per loan dollar for smaller loans than larger loans even when taking into account the interest costs of funds acquisitions for the loans. It also means that the size of loans made is going to be important in the overall cost structure of various types of lenders. More will be said about costs per loan dollar in the next section.

The residual after paying operating costs and non-operating costs like interest on borrowed funds and income taxes is the return on equity, which may be distributed as dividends to owners or retained in the firm. The return to equity compensates suppliers of equity capital for the funds they invest in the firm and the risk to which these funds are exposed. Like nonfinancial firms, banks and finance companies that do not provide a return on equity that the market for equity capital requires will shrink and eventually disappear. Credit unions depend on members' share deposits for nearly all their funding. Credit union share deposits, like bank deposits, are a low-cost source of funds. Unlike most other types of lenders, credit unions are cooperative, not-for-profit organizations. As such, their net income is not subject to income taxes or equity costs, but they still must cover operating and funding costs.

## 4.3 Measuring Lending Costs

Although all lenders are subject to operating and non-operating costs, this does not mean that the costs of all lenders and loans are the same. As indicated, operating costs in the form of salaries, expenses associated with maintaining places of businesses (rents, fixtures, supplies, communications, and utilities), and legal costs due to regulation all arise from the nature of lending. All lenders must pay for them, but the costs are going to loom larger per loan dollar for those making smaller loans.

In contrast, non-operating costs, especially costs of funds acquisition, also are important to all lenders, but they increase directly and equally per lending dollar acquired and used. Thus, they increase dollar for dollar as loan size increases and loom relatively larger as a proportion of overall lending costs per loan dollar as loan size increases. For this reason, they become an important reason that lenders differ. Different proportions of fixed operating costs and variable non-operating costs per loan dollar are an important reason some lenders are low cost and others high cost on an APR basis. It is worth looking at this differentiation further.

Consider the difference between a storefront cash installment-loan lender and an automobile finance company financing the sale of new automobiles. For discussion, the installment cash

lender makes mostly \$2,000 loans for one to two years; the automobile finance company makes loans of \$20,000 and up for five years and more.

For the cash lender, the fixed part of the operating costs per loan dollar are going to be proportionately higher than for the auto finance company, making it a higher-cost lender than the auto finance source, even apart for any concern over differences in risk. For the auto company, interest costs of borrowing funds for lending in the amounts of tens of thousands of dollars per loan are going to be the predominate element of total costs. This is even truer for mortgage lenders.

Further consideration of this idea then shows, in turn, how total costs of larger-loan lenders are more sensitive to market conditions on funding costs than for small-loan cash lenders. Funding costs simply loom proportionately larger for larger-loan lenders. This phenomenon of greater sensitivity to funds cost is especially visible for mortgage loans where lending rates vary daily depending on current costs of obtaining loanable funds.

But it is the operating costs like salaries for making loans and providing reminder programs and collections, plus likely losses, that most affect the costs per loan dollar of the small-loan cash lender. As indicated earlier, their costs per loan may even be absolutely higher per loan on the smaller sizes due to risk and trickier underwriting, processing, payment reminders, and collection activities per loan on smaller loans. Auto and mortgage lenders are also subject to risk and losses but much less on average per loan dollar. In both cases, these lenders are secured with saleable collateral to limit losses.

Generalizing from this discussion and examples, lenders to consumers have different cost structures, and they differ because of them. These differences suggest that the charges they make for loans are going to differ as well. Consequently, it is worth looking more closely at the cost structures of various kinds of lenders, and in this we continue efforts of the NCCF. Like the NCCF, we do not have as much information as we would like, but some specific cost information has become available from time to time. The Taskforce recommends that scholars continue to study costs of lending, enlarging the availability of reliable cost information whenever possible. This will continue to improve understanding of lenders, how they compete with one another, and how changing costs also alter the services available to consumers over time.

## Installment Cash Loans

We begin with more discussion of traditional unsecured personal installment loans. This is not because these loans are most important in economic impact; in fact, the entire personal installment loan market is small compared with products such as auto lending, credit cards, student loans, and mortgages. We examine installment loans in some detail in part because data

on this industry have become available from time to time, but also because the NCCF Report focused on this industry, which gives the Taskforce a baseline for comparing changes over time.

Further, finance-company consumer lenders are appropriate for studying consumer lending in a statistical sense because they are single-product companies and do not require statistical cost allocations among products due to a multiplicity of products. Many finance companies focus almost exclusively on consumer loans without the cost-accounting difficulties associated with multiple-product institutions like banks. Their fund-raising side is managed by a limited number of headquarters personnel who undertake borrowing from other intermediaries in large amounts at one time. Unlike banks, most of their costs arise on the lending side. Following investigation of installment cash loans, we look at available cost information on other kinds of lenders.

The Russel Sage Foundation first examined lending costs at finance companies in the 1910s to inform its recommendations concerning rate ceilings, although its early cost work was not highly detailed.<sup>15</sup> Dauer (1944) and Smith (1964 and 1967) examined costs of consumer finance companies from the 1930s to the 1960s.<sup>16</sup> In 1968, when it legislatively established the NCCF, Congress directed it to consider the functioning of consumer-credit markets for providing consumer credit at reasonable rates. This caused the NCCF to undertake extensive data-gathering exercises and to look at data in a number of ways. In the area of lending costs, it also engaged as a consultant professor George J. Benston of the University of Rochester, who was at the time the leading expert in the country on statistical cost studies of financial institutions.

In 1972, the NCCF reviewed the underlying costs of consumer lending at considerable length in its Chapter 7. The NCCF focused especially on consumer finance companies that primarily provide small cash loans to consumers, today known as traditional installment cash lenders. They extend relatively small amounts of credit on an installment basis to riskier consumers who might have difficulty obtaining credit elsewhere.

The NCCF found that break-even interest rates for credit from consumer finance companies needed to be quite high at small-loan amounts because of the great relative weight of fixed operating costs. Their analysts showed that break-even rates (APRs) declined steeply as loan amounts increased and eventually leveled off at larger loan amounts, as fixed operating costs are

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<sup>15</sup>See LOUIS N. ROBINSON AND ROLF NUGENT, *THE REGULATION OF THE SMALL LOAN BUSINESS* (1935), and Elizabeth Anderson, *Experts, Ideas, and Policy Change: The Russell Sage Foundation and Small Loan Reform*, *THEORY AND SOCIETY* (June, 2008).

<sup>16</sup>ERNST A. DAUER, *COMPARATIVE OPERATING EXPERIENCE OF CONSUMER INSTALMENT FINANCING AGENCIES AND COMMERCIAL BANKS 1921-1941* (1944), PAUL F. SMITH, *CONSUMER CREDIT COSTS 1949-1959* (1964), and Paul F. Smith, *Recent Trends in the Financial Position of Nine Major Consumer Finance Companies*, in JOHN M. CHAPMAN AND ROBERT P. SHAY, EDS., *THE CONSUMER FINANCE INDUSTRY: ITS COSTS AND REGULATION* (1967).



spread across ever-larger loan amounts. Concerning these costs and their effects on rates of charge, the NCCF summarized its findings as follows (page 145): “When rate ceilings are below the levels indicated [their estimated break-even rates], staff studies show that consumer finance companies can stay in business only by greater loan sizes, limiting their risk acceptance to more affluent consumers, and [by] maintaining large volume offices.”<sup>17</sup>

For a part of its work, the NCCF used cost data assembled by professor Paul Smith of the University of Pennsylvania from nine large consumer finance companies that together accounted for about two-thirds of the receivables of consumer finance companies at the end of 1964.<sup>18</sup> Professor Smith had assembled the data as part of the consumer credit research project of the National Bureau of Economic Research (NBER) at the time, and the NCCF used it for its work in Chapter 7 of its *Report*. Professor Benston analyzed these data and another dataset with more lenders that he acquired from the National Consumer Finance Association, the trade association of these lenders. The NCCF also extensively analyzed the results of its data collection of amounts and types of consumer credit in use in 1971.

A passage in the NCCF’s *Report* shows its interest in the relationship between production costs and the availability of credit (page 139):

The staff’s empirical evidence cited in preceding sections indicated that relatively low rate ceilings—ceilings which actually influence the observed rate—are typically associated with significant reductions of credit supply in affected state markets. In the finance company segment of the personal loan market, for example, it was estimated that [statewide] supply per family began to fall where rate ceilings averaged between 28 and 30 percent. Below an average ceiling rate of about 28 percent, between 60 and 70 percent of the interstate variation in supply is accounted for by rate ceiling variations and growth. Similarly, supplies of revolving credit per family are apparently below the national average where APRs on revolving accounts are less than 18 percent. As explained earlier, such curtailments may be expected to occur whenever rate ceilings impose a price insufficient to cover the costs of extending credit. This is, of course, a fundamental proposition that applies to the production and sale of any service or commodity: If the price is not sufficient to offset costs, including normal costs of capital invested, supply is curtailed unless subsidies in some form are provided. Therefore, it is necessary to explore carefully the costs incurred in extending credit

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<sup>17</sup>Russell Sage Foundation analysts found similar experience. In an analysis of rate regulation in the early twentieth century, Nugent observed similar consequences in four states that lowered rate ceilings in 1929. The number of finance companies operating in these states declined, finance companies closed offices with smaller loan volumes, stopped making smaller loans, and illegal lenders (loan sharks) reemerged. See Rolf Nugent, *Three Experiments with Small Loan Interest Rates*, HARVARD BUSINESS REVIEW, (October, 1933). See ALSO ROBINSON AND NUGENT, *supra* note 15.

<sup>18</sup>See Smith (1967), *supra* note 16.

for purposes of corroborating the [overall] availability findings and designing recommendations for appropriate rate ceiling.

In addition to the NCCF's basic statistical work on credit amounts available in the various states, professor Benston used the cost data to undertake econometric analyses for the NCCF. He used the Smith/NBER dataset to undertake review of revenues and costs of consumer lending and to analyze whether there were economies of scale in lending according to the size of lending offices. He used the National Consumer Finance Association dataset that included more companies to study economies of scale at the firm level and analyze the costs of lending on loans of different sizes. (From 1960 through 1989, the trade association undertook an annual data-collection effort involving its finance-company members.) Benston's studies were available to the NCCF in 1972 and later appeared in the NCCF's *Technical Studies* and in a series of publications in academic journals in the 1970s. His studies for the NCCF became the basic template for the later studies using newer data, modern econometrics approaches, and more flexible mathematical functional forms to study the same and similar issues.<sup>19</sup>

Analysts in the Federal Reserve Board's Division on Research and Statistics have twice updated the NCCF's findings on small-dollar installment loans from finance companies with newer data and newer mathematical functional forms, econometrics, and calculations. The first was in 1998, using 1987 data similar to that obtained by Benston for the NCCF in 1971. The second was in 2020 using information from the Board's 2015 survey of finance companies.<sup>20</sup>

Chen and Elliehausen reported findings from the 1998 and 2020 updates and compared them with estimates of lending costs available to the NCCF in 1972. Their Table 1 compared findings for aggregate revenues and costs for these largely single-product consumer lenders relative to their lending for data years 1964, 1987, and 2015 (see Table 4-1, below). In their introductory paragraphs, Chen and Elliehausen summarized the comparison for loan revenues, costs, and necessary break-even APRs on the loans: "In particular, this article examines the relationship of the loan amount and break-even annual percentage rates and the implications of this

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<sup>19</sup>See George J. Benston, *The Costs to Consumer Finance Companies of Extending Consumer Credit*, TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, Volume 2, Number 1 (1975); George J. Benston, *Risk on Finance Company Personal Loans*, JOURNAL OF FINANCE (May 1977); George J. Benston, *Graduated Interest Rate Ceilings by Size of Small Consumer Cash Loans*, JOURNAL OF FINANCE (June 1977); and George J. Benston, *Rate Ceiling Implications of the Cost Structure of Consumer Finance Companies*, JOURNAL OF FINANCE (September 1977). See also Thomas A. Durkin, *Consumer Loan Costs and the Regulatory Basis of Loan Sharking*, JOURNAL OF BANK RESEARCH (Summer 1977), which analyzes another dataset collected for the National Commission on Consumer Finance using similar methodology. Benston developed the basics of the methodology in his studies of cost economies of scale of commercial banks in the 1960s, an issue related to banking competition.

<sup>20</sup>Thomas A. Durkin and Gregory Elliehausen, *The Cost Structure of the Consumer Finance Industry*, JOURNAL OF FINANCIAL SERVICES RESEARCH (February, 1998); Lisa Chen and Gregory Elliehausen, *The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies*, FEDS NOTES (August 2020).

relationship for rates and credit availability. Findings suggest that despite many changes since 1972, the NCCF’s [cost] conclusions are still valid today” (page 1).<sup>21</sup>

The evidence they reported shows that gross revenues of consumer finance companies from \$100 of credit rose 1964-1987 (line 1 in Table 4-1). This reflects the increase in market interest rates generally during those years. Loan revenues per \$100 of credit continued to rise 1987-2015, even though market interest rates declined during these years. This time the lending revenue effect per \$100 of loans reflects smaller average loan size over those years. (The trend of market interest rates first upward and then downward over time is visible on cost of borrowed funds, line 4A of the table.) Borrowed-funds cost increased from \$4.17 per \$100 of receivables in 1964 to \$6.05 in 1987 before falling off to \$2.28 in 2015. It is noteworthy, though not surprising, that in all three years the cost of borrowed funds relative to \$100 of lending looms small for these companies compared with operating costs.

**TABLE 4-1: LOAN REVENUE AND COSTS OF TRADITIONAL INSTALLMENT, CASH LENDERS, SELECTED YEARS, (PER \$100 OF RECEIVABLES)**

	1964	1987	2015
1. Gross Revenues (Finance charges and other income)	21.40	24.89	29.09
2. Operating Expenses	12.73	15.16	20.74
2a. Salaries and Wages	5.60	6.52	8.77
2b. Other Operating Expenses	4.87	6.13	6.10
2c. Additions to Loss Reserves	2.27	2.11	5.87
3. Net Operating Income (Line 1 less Line 2)	8.67	9.73	8.35
4. Non-operating Expenses	6.34	7.51	4.40
4a. Cost of Borrowed Funds	4.17	6.05	2.28
4b. Income Taxes	2.17	1.46	1.27
5. Total Expenses (Line 2 plus Line 4)	19.07	22.67	25.19
6. Net Income (Line 1 less Line 5)	2.33	2.22	4.80
7. Notation: Average amount of receivables per account (dollars)	485	3103	2289

<sup>21</sup>Chen and Elliehausen sourced their Table 1 (Table 4-1 here) from data underlying a broader description and review of the 2015 finance company survey in Lisa Chen, Gregory Elliehausen, and Mark Wicks, *Survey of Finance Companies, 2015*, FEDERAL RESERVE BULLETIN, Table 10 (June 2018).

Source: Lisa Chen and Gregory Elliehausen, “The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board’s 2015 Survey of Finance Companies,” *Feds Notes*, April, August, Table 1.

The table shows that total operating expenses relative to credit (line 2) increased over time, due both to higher salaries and greater losses (lines 2A and 2C). Higher salary scales might well have been mitigated for these companies by greater efficiency through various sorts of office and lending automation over the years 1987-2015 but not relative to loan amounts, as average loan size decreased 1987-2015 (line 7).

The impact of the industry’s taking on smaller, undoubtedly riskier, loans on average after 1987 is visible in losses relative to credit (line 2C). Despite these changes, net profitability per \$100 of receivables varied relatively little over the period (line 6). Lower funding costs raised this measure in 2015, but return on assets for personal loan companies in 2015 was lower in 2015 than it had been in 1959 (not in table, see Chen, Elliehausen, and Wicks (2018), Table 10).<sup>22</sup>

Chen and Elliehausen then calculated loan costs by loan size using the methodology developed by Benston for the NCCF. They found that lending costs per loan rose as loan size increased in each of the three years studied, but well less than proportionately. Their results were similar for loans of consistent sizes in constant dollars over the three years, but their text focused on the 1964 data since the NCCF studied that year (page 5):

The Commission estimated costs for loan amounts ranging from \$100 to \$3,000 (\$594 to \$17,805, in 2015 dollars). Estimated costs rose from \$55.06 for a \$100 loan to \$231.80 for a \$3,000 loan (Figure 1). As a percentage of the loan amount, however, costs declined. Costs declined from a little more than half the loan amount for a loan of \$100 to 7.73 percent of the loan amount for a loan of \$3,000 (Figure 1). As a percentage of loan amount, costs decline steeply at first and then more gradually as loan amount continues to rise. These findings are consistent with economies in regard to loan amount. *That is, loan costs increase less than proportionately with loan amount* [emphasis added].

With the cost results, it was then possible for Chen and Elliehausen to calculate APRs necessary to cover these costs at various loan sizes. They called these rates “break-even APRs” and calculated them for one-year installment loans for each of the three data years.<sup>23</sup> They displayed

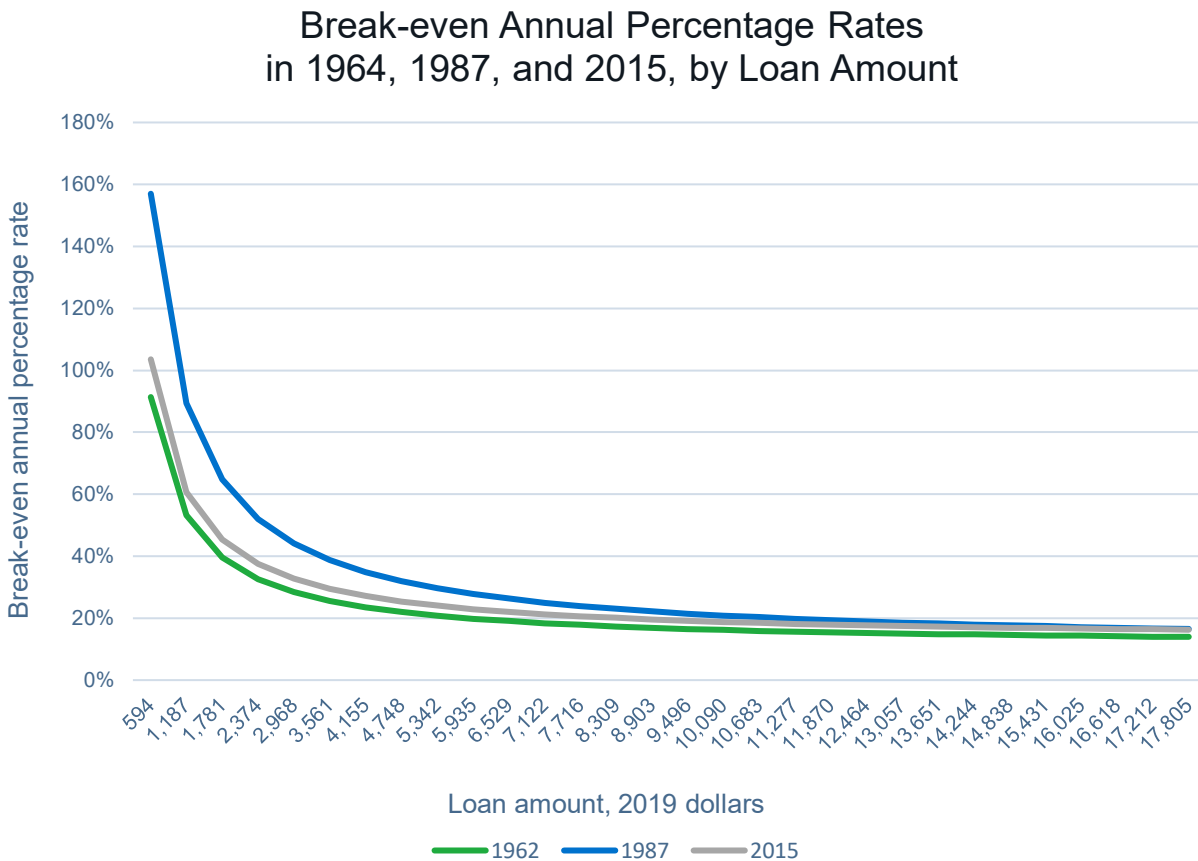
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<sup>22</sup>Lisa Chen, Gregory Elliehausen, and Mark Wicks (2018), *supra* note 21, Table 10.

<sup>23</sup>The NCCF specifically noted in its *Report* that APRs on loans made for a shorter interval would have to be higher due to being able to earn revenue for less time but that operating costs would still need to be recovered. According to the Commission (p. 145): “Recognizing that loans of [typical small sizes found then], the required APR will be higher than in Exhibit 7-16 [of the Commission’s *Report*] because the costs of putting the loan on the books and servicing it must be recaptured over the shorter time.”

the results in their Chart 5, reproduced here as Figure 4-1. Again, results for the three years studied were very similar (see Figure 4-1).

**FIGURE 4-1:** BREAK-EVEN ANNUAL PERCENTAGE RATES IN 1964, 1987, AND 2015 BY LOAN AMOUNT



Sources: Data from Federal Reserve Board.

Table 4-2 contains a few examples for selected loan sizes developed by solving the equations underlying Figure 4-1 for the specific loan sizes. They show how the break-even APRs for loan amounts in constant dollars are remarkably similar in 2015 to those in 1964 and show the same pattern in 1987. (Figure 4-1 shows the complete range of possible loan sizes in graphical form.)

**TABLE 4-2:** CALCULATED REQUIRED MINIMUM LOAN SIZE AT SELECTED APRS FOR TRADITIONAL INSTALLMENT CASH LENDERS, SELECTED YEARS (LOAN SIZES IN 2015 DOLLARS)

Selected APRs	1964	1987	2015
100	688	1187	620
60	1300	2259	1203
42	2072	3647	1994
36	2569	4550	2532

Source: Calculated from Lisa Chen and Gregory Elliehausen, “The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board’s 2015 Survey of Finance Companies,” *Feds Notes*, August, 2020.

Significantly, this table illustrates how installment cash lenders in 2015 would be unwilling to make loans at 36 percent APR smaller than about \$2,500. At 60 percent APR, they would not want to make loans smaller than about \$1,200 in 2015, and at 100 percent not smaller than about \$600. In inflation-adjusted amounts, these loan sizes are very close to the NCCF estimates in 1972 of necessary loan sizes for year 1964 (see lower panel of Table 4-2). In 1987, when salaries, other operating costs, and funds costs were higher relative to lending amounts than in the other years, profitable lending required loan sizes that were larger but not dramatically different from the other years, and the pattern is similar.

And so, the contentions of the NCCF about installment lending are borne out by the newer statistical analysis: Rate ceilings on cash installment loans are not so much a limitation upon the revenues and profits of lenders as they are a determinant of the sizes of loans that lenders are willing to make. Borrowers of small amounts appear to be riskier than mainstream borrowers as shown by high operating costs and sizeable losses for lenders in this market. As shown by analysis of costs of these largely single-product credit sources over time, higher rates are necessary to make smaller loans available. The next chapter discusses these lenders further in the context of the kinds of lenders that operate in the small-dollar area.

## Credit Cards and Other Consumer Lending Costs

The NCCF also considered costs of other institutions. Only limited further information about other institutions in the post-automation era is available, but these data at least provides an empirical feel for the differences in consumer-lending costs among classes of financial institutions.

For instance, for decades the Federal Reserve collected data on costs of different functions (like consumer lending) undertaken by commercial banks over the period 1957-98. The purpose of

the program was to help individual banks understand and control their own costs by being able to compare them to the costs of other banks. Newer data are not available, but the old information shows that banks were lower-cost lenders both in terms of their operating costs and non-operating costs such as costs of loanable funds.<sup>24</sup>

By staying away from smaller consumer loans except through their credit-card programs, operating costs and losses per consumer-loan dollar were considerably lower for commercial banks than for consumer finance companies. Combining this advantage with their lower-cost “internal funding” enabled the banking industry to dominate the consumer lending market for larger loan sizes to less-risky borrowers, like new auto credit, for decades. (More recently, aggressive competitive response by manufacturers’ auto-finance “captive” subsidiaries has enabled them to recapture sizeable market share in this area.) Except for credit cards, banks have not been successful in competing in the smaller-dollar lending area where they have encountered the same sorts of high operating costs per loan dollar and higher losses experienced by consumer finance companies.<sup>25</sup>

But credit-card programs are not like bank installment loans either, in that they must deal with ongoing advances of small amounts of credit worldwide and the capital-intensive and expensive systems these products entail. The credit advances also are unsecured, so costs and losses also arise on that basis. According to Federal Reserve figures, in the fourth quarter of 2019 (before the pandemic) bank losses on credit-card programs were 3.70 percent, about four times the loss rate on other bank consumer credit.<sup>26</sup>

Looking at the cost of card programs further, in the past Visa, Inc. periodically sponsored its own functional cost study to provide cost benchmarks to its members. The most recent survey available from 1994 also shows operating costs, including losses, per loan dollar to be above costs of other consumer lending by commercial banks although less than consumer finance companies.<sup>27</sup> Losses were the largest component of operating costs followed by wages and salaries. This is not especially surprising. Account size is smaller for card lenders than for typical bank closed-end consumer lending and larger than for the finance company small-dollar loans

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<sup>24</sup>See Evren Ors, Postmortem on the Federal Reserve’s Functional Cost Program: How Useful Was the FCA? REVIEW OF FINANCIAL ECONOMICS, numbers 1-2 (2004).

<sup>25</sup>See Rae-Ann Miller, Susan Burhouse, Luke Reynolds, and Aileen G. Sampson, *A Template for Success: The FDIC’s Small Dollar Loan Pilot Program*, FDIC QUARTERLY, number 2 (2010).

<sup>26</sup>Board of Governors of the Federal Reserve System, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, Statistical Release, August 24, 2020.

<sup>27</sup>See Visa, USA, *1995 Functional Cost Study* (San Mateo, CA: Visa Business Research and Reporting Department, 1995).



and there is ongoing need for expensive processing and communications for millions of small credit transactions and payments.

The Visa figures for 1994 show that operating costs accounted for 44.6 percent of total revenue, and funding costs only 31.1 percent. This means that APRs on credit card accounts will also be less based upon and less sensitive to funding costs than to operating costs per loan dollar.<sup>28</sup>

In 2006, the Governmental Accountability Office (GAO) found a similar relationship. Comparing credit card operations of a sample of large banks to “consumer lenders,” by which discussion in the report shows they meant bank new-auto and personal loans, they found that credit-card operating costs were considerably higher than for “consumer lenders.” According to the GAO report, “As a result, the average operating expense, as a percentage of total assets for banks that focus on credit card lending, averaged over 9 percent in 2005, as shown in Figure 31 [not reproduced here], which was well above the 3.44 percent average for other consumer lenders.”<sup>29</sup> This again shows that operating expenses on credit card operations loom large relative to revenues on small balances. They are the reason why account APRs on credit card accounts, like those on other sorts of small dollar credit, are higher than on mainstream larger accounts and do not vary as much with funding costs.

Thus, it is worth noting again that the relative contribution of cost of funds to the final price of various loan products is also going to be reflected in the degree of responsiveness in their prices to changes in the underlying cost of funds. For instance, if cost of funds is a smaller proportion of total costs for credit-card programs than for other kinds of mainstream consumer lending, then card rates will not adjust as much to changes in the underlying cost of funds as other products, such as automobile loans and mortgages. This is the well-known credit card “stickiness” issue sometimes suggested in the past as a market failure when cost of funds declines.<sup>30</sup> This ignores how credit card interest rates also do not rise as much when underlying interest rates rise either. For example, during the period between 1982-9 when market interest rates rose, card interest rates rose only slightly. By contrast, interest rates on mortgages and car loans rose proportionately more, tracking more closely changes in the underlying cost of funds.

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<sup>28</sup>Focusing on percentages of total costs rather than total revenues, Federal Reserve analysts around the same time found, not surprisingly, a similar relationship. Canner and Luckett calculated that operating costs of credit-card plans including servicing accounts, soliciting new accounts, and processing sales accounted for nearly 60 percent of total costs and the cost of funds only 27 percent with the remainder attributable to charge offs. See Glenn B. Canner and Charles A. Luckett, *Developments in the Pricing of Credit Card Services*, FEDERAL RESERVE BULLETIN, (September 1992).

<sup>29</sup>UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES TO CONSUMERS, 100 (2006).

<sup>30</sup> For discussion see Todd J. Zywicki, The Economics of Credit Cards, CHAPMAN LAW REVIEW 79, 111 (2000). See also Kathleen W. Johnson, Recent Developments in the Credit Card Market and the Financial Obligations Ratio, FEDERAL RESERVE BULLETIN, (Autumn 2005).

And so from this cost information, even if less complete than preferable, a hierarchy in the cost structures of these consumer-lending institutions is visible. Banks' closed-end lending exhibits the lowest costs per loan dollar, followed upward by bank credit-card programs and then consumer finance-company cash installment loans. Given the smaller size and greater risk of consumer finance company loans and credit-card loans, it is not surprising that suppliers must charge more for these lending products if they are to stay in business or that rates of charge on these products are less sensitive to costs of funds than mortgage loans. Using a sample of data from 300 offices of two large payday lenders, FDIC researchers in 2005 showed that costs of payday lenders relative to loan amounts were the highest of any lenders studied, again reflecting the small size of the loans made.<sup>32</sup> The passage of time since these studies were undertaken suggests strongly to the Taskforce the usefulness for the CFPB of undertaking new and ongoing periodic studies of the costs of consumer lending.

In sum, production costs are crucial to the willingness of financial intermediaries to supply credit to individuals, as they are to the supply of any goods or services. For lenders, costs arise in the form of operating costs associated with origination, processing, collection, and losses. Non-operating costs include taxes, interest for acquiring loanable funds, and costs of capital. As indicated earlier, economic theory, as well as experience, suggests that intermediation lowers the overall cost of the transfer of resources from ultimate savers to borrowers, but it is still true that the prices charged for loans must cover operating and non-operating costs of the lending transfer process.

Further, the type of lending determines to a large degree the mix of operating and non-operating costs with operating costs looming larger per loan dollar on small amounts of credit due to the fixed nature of some of these costs. This means that for a given maturity, the rate of charge (APR) will also be higher on the smaller amounts of credit, borne out by empirical evidence.

## 4.4 Further Discussion of Lending Costs and Annual Percentage Rates

Considering costs and APRs further, it is not likely that consumers are very interested in operating and non-operating costs of consumer lenders. Evidence shows they are interested in the finance charges and Annual Percentage Rates necessary to cover these costs, however (see Chapter 7 below).

Finance charges and Annual Percentage Rates are required disclosures under Truth in Lending and both are measures of credit price, although they are not the same. They are determined jointly in the marketplace by the interaction of credit demand (arising from usefulness of credit)

and its supply (dependent on production cost), as long as there is no external interference with the market (like controls).

Observers of Truth in Lending, including legislators and regulators but also anyone else interested in this area, should be careful to understand both of these price measures conceptually, because even though they are determined jointly under a single set of rules, they are not the same and do not have necessarily have the same uses. Using them wrongly could lead to a wrong decision.

The Truth in Lending “finance charge” is the cost of some specific amount of credit over some period of time expressed in dollars. In contrast, the APR is conceptually more like a “unit price” measurement of the price of the credit relative to credit amount over a specific unit of time, notably over a year.

It turns out, that both the finance charge and the APR can be more or less useful in decision making depending on the circumstances. As with a home chef contemplating a new and difficult recipe, a low unit price offered on a huge jar of some new and previously obscure ingredient may not represent the best bargain. The small jar of the right amount at a higher unit cost but lower dollar cost may be a better choice than the one at a lower unit price but costing more dollars. This, of course, does not argue in any way for not disclosing either the unit price or the dollar price.

Because they are determined jointly by demand and supply, there is no reason to assume that either of these price measures determined in a credit arrangement is in any sense “wrong,” although almost everyone always wants prices of anything to be lower. The NCCF argued strongly and continuously in its Report in 1972 for ongoing government encouragement of competition in the granting of consumer credit, so that prices would be both “fair” and the lowest possible for given production costs. This Taskforce joins the NCCF in its insistence in the importance of competition, and, fortunately, it appears that consumer credit markets are more competitive today than in the NCCF’s time (see Chapter 8 below). Truth in Lending undoubtedly should receive some of the thanks for this. But, as indicated, which measure of price is most useful in determining price that is “too high” relative to usefulness of the product can depend on the circumstances.

Experience shows that both the APR (unit price) and the finance charge are extremely important disclosures required by Truth in Lending, but also that neither is the most useful term to all consumers in all situations. Although experience indicates that most consumers will find APR useful for most decisions to at least some extent, different uses of the two price concepts should be understood for situations where the distinction is relevant. In particular, use of restrictions on unit prices (APRs) to implement a system of price controls on lending can interfere with the best dollar prices available for small preferred amounts of the product (credit). This could

happen in the same way that restrictions on allowable unit prices of menu ingredients could frustrate chefs when it means that only larger jars that are more expensive in dollars jars are available.

In light of the previous discussion about how fixed costs cause differences in necessary prices for loans of different sizes, some further lending examples seem useful. Like with the chef's ingredients, it is possible for a loan with a lower unit price to have a higher dollar cost due to different sizes and maturities. The correct decision rule for the credit user in these situations (as for the chef) is not necessarily the lowest available unit price but rather the lowest available unit price for the needed amount and loan maturity. This produces the lowest available cost, the lowest available finance charge for the amount of credit and maturity in question.

Congress should receive its own credit for understanding the importance of both prices (finance charges) and unit prices (APRs) when it passed Truth in Lending in 1968 and required disclosure of both. Complaints arise from time to time that only one or the other is useful in certain situations, but any proposals for manipulating either concept that changes its usefulness or for encouraging sole focus on one or the other for normal kinds of consumer credit risks encouraging unwise credit decisions. The most useful approach is to recognize the situations in which the information conveyed by the two cost conceptions can be most useful and to be very careful what can happen when regulating by either. A few examples are in order.

Suppose that in some state there is demand for loans across a spectrum of loan sizes \$500 and up. Suppose that this state permits rates approximating those indicated by the National Commission on Consumer Finance and Figure 4-1, for example APR of 95 percent on a \$500 loan for six months and 72 percent for a \$1000 loan for one year. Terms of these loans are as follows:

Small Loan

Amount	\$500
APR	95 percent
Maturity	6 months
Payment size	\$107.88
Finance charge	\$147.31

Small Loan

Amount	\$1000
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APR	72 percent
Maturity	12 months
Payment size	\$119.28
Finance charge	\$431.32

Now, suppose for illustration that some other state limits the unit price (APR) to 27 percent. Based upon Figure 4-1, lenders would be unwilling to make these small cash installment loans in this state, due to insufficient revenue to cover costs. Suppose that lenders are willing to make loans at the lower rate if they are larger, however. To keep payment size down and to allow additional revenue to accrue, the loans also have longer maturities.

Suppose that lenders in this other state are willing to make loans of \$2000 for two years at 27 percent APR. If this is the only sort of loan available to some borrower (because the borrower has no available credit-card credit), simple calculations show that monthly payments are about the same as on the \$500 at 95 percent but the price (finance charge) is four times as high:

#### Larger Loan

Amount	\$2000
APR	27 percent
Maturity	24 months
Payment size	\$108.76
Finance charge	\$610.25

The example shows that the borrower really needing only \$500 and willing to repay over six months at 95 percent pays less than one quarter of the amount of the finance charge on the loan than the borrower at 27 percent (\$147.31 versus \$610.25). The difference arises because the loan available in the second state is both larger and longer. It clear that the second borrower is worse off, despite the much lower unit price (APR). The same is true for the borrower who needs a loan of \$1000 for one year. In the first state the APR is 72 percent with accompanying finance charge of \$431.32. In the second state the rate is lower at 27 percent but the loan is larger and longer resulting in a higher finance charge of \$610.25. The borrower of the larger, longer loan at the lower rate could, of course, reduce the cost of the loan by fully paying it off early, but it is not clear how often this might occur. It also is not clear how many lower rate lenders would remain in the market if substantial proportions of their low-rate loans paid early.

Thus, this discussion assumes that the lender is willing to make the \$2000 loan for two years. And, if either loan size or maturity becomes larger, the loan at the lower rate becomes even more expensive. For example, the next example below is for a \$4000 loan with a 36 month maturity to make the payments affordable at this loan size. In this case, the finance charge is more than ten times the amount in the \$500 loan for six months, despite the much lower APR (27 percent versus 95 percent). For a borrower in need of \$500, borrowing \$4000 to arrange credit availability is much more expensive than the \$500 loan size needed size at an APR of 95 percent:

Larger Loan

Amount	\$4000
APR	27 percent
Maturity	36 months
Payment size	\$163.30
Finance charge	\$1878.83

And so, the APR is a complete guide to the least expensive loan when the amount of the loan and its maturity are constant, but is only a partial guide otherwise. On small-dollar loans where size, rate, and maturity can all easily double or triple in size, more evaluation is necessary than just looking at the APR. As the examples here show, sometimes the highest APR can even produce the least-cost loan in dollars. In these situations regulating by the unit price eliminates the lower cost alternative in dollars. Not very surprisingly, users of small-dollar credit appear to find the dollar amount of the finance charge to be an important for understanding a loan's cost. There is more discussion of this research finding in the next chapter.

## 5. Small-dollar lending: the perennial problem

The modern American consumer economy has become a triumph in the modern world with the way it has facilitated higher quality of life for the majority of people. An important part of this triumph has been market-based credit for consumers who would not otherwise have ready access to the cash needed to change the timing of purchases in preferred ways and to minimize the effects of emergencies in ways that improve the quality of life. Beginning over a century ago, retail sources, manufacturers, and financial institutions began to provide mechanisms for consumers to change the scheduling of large purchases that provide a future return to a preferred purchase pattern. Although changing the time of purchase might sound mostly mundane, development of consumer and housing credit has enabled consumers to acquire homes, transportation, other durable goods, college educations, and needed services that provide a return over time at an earlier period in their life cycles than would otherwise have been possible. Acquiring them early is when they are most valuable, rather than saving and acquiring them only later, a process that can be slow and costly since it requires substitutes during the process.

The consumer-credit system has become intertwined with the growth of the American middle class and movement to the suburbs in the post-World War II era. Middle-class families today encounter a world of mainstream credit: bank loans, credit cards (largely replacing the retail installment sales and cash credit from retail stores and finance companies in earlier generations), automobile loans, student loans, and mortgage loans for housing. These mainstream credit products account for the overwhelming portion of credit for consumers in the United States today.

By contrast, many lower-income and other credit-constrained households encounter a different world. Although they often have access to mainstream credit products, that access can be more limited than for middle-class consumers. This fact sometimes leads them to supplemental credit suppliers at higher prices, as discussed by theorists/empiricists Juster and Shay and others. Yet they benefit from access to credit for the same reasons as middle-class consumers. They too use credit to purchase transportation to commute to jobs, for purchasing appliances like washing

machines and refrigerators that provide a return over time, to manage the expensive challenges of children, and to mitigate emergency situations.

The challenge of small-dollar credit arises from the reality for many consumers, especially younger families, that their demand for credit often exceeds the available supply at mainstream prices. As discussed in Chapter 3, early in their financial life-cycle consumers have many very high-value investment opportunities, including consumer durable goods that provide a regular return over time. They also have emergencies that occur and that necessitate access to additional resources. But at the same time that consumer demand for credit is highest, credit supply is at its lowest state. For most people, one's starting salary is as low as it ever will be. Further, younger people typically own few assets (such as cars or real estate), have modest savings and financial investments (if any), a largely unproven credit record, and minimal experience with financial products. Even many middle-class college graduates owe substantial amounts on student loans upon graduation and are technically insolvent from the moment they reach the other side of the graduation stage.

In short, for millions of individuals, especially younger ones, their demand for additional credit is highest at the stage of their lives when their available supply of credit likely is lowest. As will be discussed, this means that many consumers are “rationed” in their credit access. As a result, many consumers are unable to meet all of their credit demand through mainstream financial providers, yet the demand remains. This dynamic is what gives rise to particular characteristics of the small-dollar loan market, which we explore in this chapter. The perennial problem of small-dollar credit has been enabling rationed consumers to gain access to needed credit at what is considered by observers to be a “reasonable” price instead of the price established through the free interplay of supply and demand. It is precisely this difficulty that has given rise to the recurrent experiences with interest-rate ceilings through history.

After reviewing millennia of history, centuries of economic theory, and decades of empirical analysis, the Taskforce concludes that the problem of providing small-dollar credit to wage-earners at what others consider to be “reasonable” prices is not only a perennial problem but is probably also unsolvable. Either small-dollar credit can be provided at market prices that take into account its production costs, it can be provided by massive governmental intervention at a cost that has never yet been politically acceptable (and which still would have to contend with operating costs), or it will not be provided at all. Legislative or regulatory mandates to set different prices cannot change those realities. So federal and state legislators are faced with a difficult choice.



## 5.1 The Economics of Small-Dollar Lending

Small-dollar lending is a distinct market with some submarkets for different kinds of small-dollar loans (specific kinds and estimated amounts are discussed later). But this does not mean that its economics is unique. As noted earlier, there have been constraints on lenders throughout history (Chapter 2 above), but there still is demand for credit based upon its usefulness (Chapter 3), and supply is still determined by its costs (Chapter 4). Attempts to subvert these realities at various times have continuously led to unintended consequences: unmet needs, evasions, and calls for new regulation in an unending cycle. The difference in small-dollar lending arises from its special constraints on both consumers (like liquidity challenges and poor credit history) and providers (costs and regulations), not from its fundamental economics.

The National Commission on Consumer Finance (NCCF) discussed in 1972 how all potential lending institutions face the restrictions on lending dictated by their cost structures, not just consumer finance companies whose costs are discussed at further length above in Chapter 4. Sometimes the view is heard that there was some time in the past that banks were better able to provide small-loan services than in more recent history when technological change has led them to providing smaller credit amounts only through their more restrictive credit-card programs. This is not the case. Writing before much of the growth in card programs that took place in the 1970s and 1980s, the Commission noted (p. 141):

The costs of commercial banks reflect the grade of credit risks acceptable under their established finance rates, which are typically below their rate ceilings. Often by choice and sometimes because of low rate ceilings, commercial banks generally serve a less risky and, therefore, less costly segment of the market than finance companies. There is not, however, a clear delineation between the markets. Commercial banks must perform the same basic services as other credit grantors, and the costs of many of these services are fixed, regardless of the amount of credit extended.

The Commission then went on to discuss further the cost structure of personal lending by commercial banks at the time using data available then. The Commission found banks' cost curves by loan size similar to those of consumer finance companies.

The idea that banks were not servicing the needs of small loan borrowers was not new with the Commission. For instance, writing about the experiences of railroad clerk John Doherty in 1910 as an example of conditions then, Anne Fleming noted, "For borrowers like John Doherty, in need of cash rather than credit to buy goods, there were a number of sources available. Banks were not among them, however. Commercial banks did not make small loans, particularly to low-income working-class borrowers." Writing about 1937, she added, "Personal finance

companies and banks did not serve the same clientele, however. In the 1930s and 40s, bank borrowers usually had higher incomes than clients of personal finance companies, who were drawn from the ‘lower middle income and lower income groups.’<sup>1</sup>

## The Fundamentals

In their economic analysis of credit-use decisions in 1964 (discussed here in Chapter 3 as part of the development of the economics of consumer credit), Juster and Shay explained the theoretical reasons why consumers are sometimes willing to borrow at high rates of interest. To summarize, rates of return for benefits of purchases made on credit can be quite high and under the circumstances households would be willing to borrow to make these purchases or mitigate emergencies.

But because income and accumulated savings of borrowers are often limited, primary lenders (low-rate lenders) limit the amount of credit they are willing to offer them. This means benefits from some additional consumer expenditure might exceed the borrowing cost from primary lenders but primary lenders are unwilling to lend more. Low-rate lenders may be unwilling to lend at all to some potential borrowers desiring credit. This is known as credit rationing and it is discussed further next. A continuum of specialized secondary lenders willing to lend small amounts might arise and relax the credit constraint and in many situations provide solutions to needs and problems, increasing overall consumer utility. But lending small amounts is costly due to operating costs and higher risks.

Chapter 4 examined credit supply and showed where lending costs come from: Credit involves a production process called financial intermediation that provides services but also entails costs. There are production costs consisting of origination, processing, bad-debt, and capital costs. These production costs include more than simple forbearance cost that arises from giving up alternative uses of the funds by the lender (historically called “interest”). Production costs were understood even in medieval times when rate ceilings were part of religious law that prevailed in most of Europe then. The framers of the Truth in Lending Act understood this too, and they defined the cost of credit as the “finance charge” and not “interest.”

Chapter 4 also looked at the economic reasons why supplying a small-dollar loan is more costly per loan dollar than supplying a mainstream loan: many *operating* costs of lending are fixed costs or close to fixed. Fixed operating costs then loom larger and larger per loan dollar as the loan size becomes smaller and smaller.

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<sup>1</sup> ANNE FLEMING, CITY OF DEBTORS (2018), p. 21 and p. 97, respectively.

In contrast and unlike operating costs, costs of loanable funds increase proportionally as loan size increases. For example, interest paid on the second million or billion dollars of loanable funds for a lender to use to make new-auto loans is going to be much the same as the interest paid on the first million or billion dollars of loanable funds. In other words, cost of obtaining the loanable funds is going to be much the same for each lendable dollar in a particular capital market, up to the limit of the lender to obtain those funds. This means that as loan size becomes smaller, total *funding costs* loom smaller compared to fixed operating costs on a smaller and smaller consumer loan until most of the loan cost on a tiny loan is due to operating cost. Conversely, total funding costs loom larger compared to operating costs as loans become larger, until most of the cost of the loan is funding cost on a very large loan.

Not surprisingly, these relationships produce a hierarchy of economic lending costs per loan dollar for consumer lending. Costs of making small loans are going to approximate the operating costs. Since, as shown in Chapter 4, the operating costs on a small loan are high per loan dollar, so is the total cost of the loan per loan dollar. In contrast, for large loans the operating costs per loan dollar almost disappear compared to the funding costs, and the funding costs dominate. For the small loans, operating costs dominate.

But even so, other things are still not equal: It is also reasonable to expect, and empirical information demonstrates, that small loans are also typically riskier for lenders than larger loans due to the circumstances of borrowers who need small loans. This adds to operating costs of lending smaller amounts. As discussed at greater length in Chapter 4, additional costs of managing risk and the possibility of losses can make producing small loans even absolutely more expensive than larger loans, and not just relatively per loan dollar. So, if small loans are more costly to make per loan per loan dollar than larger loans, finance charges per loan dollar and accompanying APRs will also have to be higher on small loans to cover costs and make lenders willing to lend.

Even though these ideas have been basically understood since at least the middle ages, this does not make them satisfactory, or even acceptable, to many observers. Consequently, attempts to change and subvert the basic economics of lending through price ceilings have existed throughout history. These attempts have enhanced the reality of credit rationing, the situation where credit supply falls short of demand at the market price.

## The Realities of Credit Rationing

In modern terms, those frozen out by the system become “rationed borrowers” in Juster and Shay’s terminology.<sup>2</sup> If rate ceilings are set relatively low, all borrowers become restricted to “primary lenders” that make loans at low rates, which typically excludes small loans. If ceilings are somewhat higher, there can also be “secondary lenders” in the marketplace that expand the availability of legal credit. Even if there were no ceilings, however, lenders will limit the amount of credit of both kinds at some point. The economic theory of credit rationing predicts that lenders will restrict credit when risk and other costs exceed profit potential, and experience shows this is what happens.

Modern economic theory of credit rationing based upon statistical conceptions of risk has become another highly technical and mathematical area of economic theory, but, as indicated, the underlying economic concepts are clear enough and have been understood and discussed for centuries.

Credit is like other goods and services in that revenues must cover operating and nonoperating costs or suppliers will not provide it. It is not like other goods and services, however, in that, as indicated, its providers are also subject to one more cost aspect that arises from its intertemporal nature: how the repayments are expected after or over a period of time. This aspect of lending generates uncertainty and risk about whether the future promised payments actually will be received, and this risk of nonpayment is potentially costly. Much of the art and science of consumer lending goes into managing this nonpayment (default) risk.

Modern economic theory of credit rationing shows that even in a lending market completely unconstrained by price ceilings lenders will not lend unlimited amounts, since as they lend default risk rises. At the time of development of modern economic theory in this area that included also the work of many others, Juster and Shay pointed out that at some point primary (low-rate) lenders would be unwilling to lend more, even if borrowers were willing to borrow more at the same rates. In these cases, individuals seeking more credit would need to turn to secondary (higher-rate) lenders.

Due to default risk, at some point even the secondary lenders would be unwilling to lend more. In both cases, default risk produces a situation where there might not be normal supply-demand equilibrium through a market-clearing price because under conditions of increasing default risk

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<sup>2</sup>See F. THOMAS JUSTER and ROBERT P. SHAY, CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION (1964).

lenders are unwilling to supply more credit. Although specifics of the complete theory are considerably more complicated than discussed here, the result is credit rationing.<sup>3</sup>

Juster and Shay's theoretical analysis produced two types of outcomes, an equilibrium outcome and a rationing outcome. They considered first a simple example in which there are two borrowing rates, a lower rate charged by primary lenders and a higher rate charged by supplemental lenders. Both sorts of lenders have an absolute limit on the amount that can be borrowed. The consumer undertakes household-related investments until the rate of return on investment equals the borrowing rate charged by primary lenders. In this case, the amount borrowed does not exceed the limit set by primary lenders.

Rationing outcomes occur when the consumer is unable to equate the rate of return and the borrowing rate because lenders are not willing to lend more even if the rate is acceptable to potential customers. There are two rationing situations. The first occurs when the consumer is willing to take on the debt at the rate available from primary lenders, but the absolute limit on the amount of credit available from primary lenders prevents a consumer from borrowing further at their lower rate (rationing). In this case, the return on investment for the borrower is not sufficiently high to justify borrowing at the next higher available rate and borrowing stops.

A second rationing outcome occurs when the consumer exhausts availability of credit at the lower rate charged by primary lenders and borrows at the higher rate of the next of a tier of secondary lenders. The borrower's rate of return and rate of time preference may be equal to the higher rate charged by supplemental lenders, but no loan will be forthcoming if the amount of borrowing exceeds the supplemental lenders' limit at this higher rate. Again, rationing takes place and can prevent the individual from taking advantage of an available opportunity (or satisfy a necessity or emergency).

These theoretical contentions are consistent with empirical evidence. It is well known that many good credit risks do not borrow the full amounts that primary (low-rate) lenders are willing to lend them (that is, their expected rate of return on additional credit use is less than the borrowing rate for them). This is not rationing but is choice based upon supply and demand. It is equally well known that lower-rate lenders limit borrowing at their normal rates of charge,

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<sup>3</sup> For the classic modern discussion of credit rationing, see Dwight M. Jaffee and Franco Modigliani, A Theory and Test of Credit Rationing, *AMERICAN ECONOMIC REVIEW*, (December 1969), and Dwight M. Jaffee and Thomas Russell, Imperfect Information, Uncertainty, and Credit Rationing, *QUARTERLY JOURNAL OF ECONOMICS*, (November 1976). Precise discussion of the neoclassical economics of credit rationing requires graphical and/or mathematical presentation using calculus. See THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI *CONSUMER CREDIT AND THE AMERICAN ECONOMY* (2014), which provides discussion and graphs of these and other technical analyses of credit rationing in their Chapter 5 and its mathematical appendix.

however, even if borrowers are sometimes willing to borrow more at these rates. It is also well known that even secondary lenders are unwilling to lend unlimited amounts.

Although the complete theory of credit rationing allows for its existence even in the absence of some sort of external limitation on price, price limits established by governments have been the most common cause of credit rationing historically. As with any product, producers of consumer credit must cover their costs if they are to remain in business. For lending, expected default costs are part of the cost structure that lenders must consider and cover. As outlined briefly above in Chapter 2 above and at somewhat greater length by the NCCF in its Chapter 6, price ceilings established by government action have constrained lenders attempting to cover costs since ancient times.<sup>4</sup>

Theoretical development suggests that borrowers potentially rationed will tend to have relatively low or moderate current incomes and little discretionary income. Without credit, they would have to make large sacrifices in current consumption to pay for large or unexpected current expenses, making the purchases personally very costly. Because of moderate incomes and often younger age, these rationed borrowers generally would not have accumulated large amounts of liquid assets. At this stage in their life cycle, any liquid asset holdings for these individuals would have a high subjective yield anyway, because of precautionary needs, and they might well prefer not to use them.<sup>5</sup>

Available evidence shows that this theoretical profile does indeed describe users of small-dollar consumer credit. Surveys of small-dollar borrowers show that they are younger, lower-income, and more credit-constrained than non-users of these kinds of credit (Table 5-1). This means they will disproportionately include individuals with higher potential demand for credit use (greater returns) and lower potential credit supply. They are users of mainstream consumer credit when possible, but typically they have fewer sources when needed and more difficulty in obtaining mainstream credit.

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<sup>4</sup>See also SIDNEY HOMER AND RICHARD SYLLA, A HISTORY OF INTEREST RATES, 3<sup>RD</sup> ED. (1996).

<sup>5</sup>For discussion of importance of precautionary reserves to individuals, see GEORGE KATONA, PSYCHOLOGICAL ECONOMICS (1975), especially chapter 16.

**TABLE 5-1: DEMOGRAPHIC INFORMATION ON SMALL-DOLLAR BORROWERS IN 2015**

	Pawn loan	Vehicle title	Payday loan	Non users
<b>Approximate Annual Household Income (\$thousands)</b>				
Less than \$15	21	9	13	10
15-24	19	11	14	10
25-34	16	14	15	10
35-49	16	15	16	14
50-74	16	23	21	21
\$75 or more	12	29	22	36
Total	100	100	100	100
<b>Age</b>				
18-24 years old	14	15	14	9
25-35	26	33	31	15
35-44	22	22	23	15
45-54	20	15	16	19
55-64	13	9	11	19
65 or older	5	6	6	22
Total	100	100	100	100
<b>Life Cycle Stage</b>				
<45, Married, has children	33	45	40	22
<45, Married, no children	1	1	1	1
<45, Not married, no children	3	3	3	2
>45, Married, has children	10	11	9	17
>45, Married, no children	8	10	8	33

>45, Not married, no children	14	8	11	15
Any age, not married, has children	31	22	29	11
Total	100	100	100	100

Note: Recent demographic information on borrowers at traditional cash installment lenders is not available.

Source of Table: Data from the 2015 National Financial Capability Study, Financial Industry Regulatory Authority (FINRA) with the US Department of the Treasury and the President’s Advisory Council on Financial Capability, as calculated and reported by J. Brandon Bolen, Gregory Elliehausen, and Thomas W. Miller, Jr., “Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research,” *Economic Inquiry*, April, 2020, Table 2.

Columns may not add to totals because of rounding.

Consistent with Juster and Shay’s theory of rationed consumers, the important characteristic of consumers who use alternative financial products is that they are constrained in their access to mainstream credit. For example, the overwhelming number of payday loan customers do not have access to credit cards or would exceed their credit limits if they tried to use them,<sup>6</sup> were recently denied access to credit,<sup>7</sup> or searched intensely for credit before accessing their first payday loan.<sup>8</sup> For auto title pawn loans, only about 20 percent of auto title loan customers had credit cards.<sup>9</sup> With respect to overdraft protection, one survey of frequent users of overdraft protection found that only 7 percent of respondents reported that they had “good” credit, compared to 32 percent who said they had “poor” credit.<sup>10</sup> Also, most studies of small-dollar lending find that consumers report that they use small-dollar lending products mostly to meet

<sup>6</sup>Elliehausen found that only about half of payday loan customer had credit cards, 67% either had no credit card or would have exceeded their credit limit if they used the card, and 90% had either no cards or less than \$300 in available credit card lines of credit). See Gregory Elliehausen, *An Analysis of Consumers’ Use of Payday Loans*, GEORGETOWN UNIVERSITY CREDIT RESEARCH CENTER MONOGRAPH, No. 41 (2009).

<sup>7</sup>See ELLIEHAUSEN (2009), *supra* note 6, also see AMANDA LOGAN AND CHRISTIAN E. WELLER, WHO BORROWS FROM PAYDAY LENDERS? AN ANALYSIS OF NEWLY AVAILABLE DATA (2009).

<sup>8</sup>See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, JOURNAL OF MONEY, CREDIT, AND BANKING, (March, 2015).

<sup>9</sup>See Jim Hawkins, Credit on Wheels: The Law and Business of Auto-Title Lending, WASHINGTON AND LEE LAW REVIEW (2012).

<sup>10</sup>See Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, WASHINGTON AND LEE LAW REVIEW (2012).



urgent and important financial obligations, such as rent, utilities, car repairs, and household necessities such as food, clothing, medicine, and gasoline.<sup>11</sup>

These survey findings are consistent with neoclassical economics that the major motivation for credit use involves situations where there is a positive return over time but rationing may affect some potential borrowers, in this case sending them to secondary lenders. There are, of course, also significant and well-known risks of unfortunate outcomes associated with any credit use, and these forms of supplementary credit are certainly not an exception.

Short term credit products can also facilitate the accumulation of household assets for credit-constrained individuals even when they are not used directly to finance the actual household investment: Availability of short term credit when needed can reduce consumers' vulnerability to unexpected expenses or short-term fluctuations in income when they already have debts involving the financing of household investment. Although these short term credit products may be very costly per loan dollar, consumer losses resulting from illiquidity may be quite large as well. Even simple late payments of utility bills due to illiquidity, for example, can cause a consumer to incur late-payment fees, loss of deposits on monthly utility bills, and reconnect fees.

Those facing such circumstances typically are at the life-cycle stage where needs and returns can be high but resources often are limited. They then become potential small-dollar borrowers from secondary lenders. It also appears that many of them age out of this kind of credit as they establish themselves financially and graduate into greater access to mainstream credit, although some do not. Further, there is a pattern whereby some products are less desirable than others based on cost and features. Thus, if credit rationing by primary lenders affects access of individuals to preferred forms of credit (including more convenient forms like credit-card credit), they can still move down the order of preference to less desirable (and typically more expensive) kinds of credit. These various sorts of small-dollar products are discussed further below.

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<sup>11</sup>See ELLIEHAUSEN (2009), *supra* note 6. See also HAWKINS (2012), *supra* note 9, and G. Michael Flores and Todd J. Zywicki, *Commentary: CFPB Study of Overdraft Programs*, MERCATUS CENTER, GEORGE MASON UNIVERSITY (2013).

## 5.2 Small Amounts of Credit in Recent History

Amounts of small-dollar credit in use today amount to only a small fraction of the approximately \$4 trillion of consumer credit in use, but the numbers are certainly consequential. The Federal Reserve does not provide estimates of amounts specifically of small-dollar consumer credit within its aggregate amounts, but others have attempted this, using various sources of data.

One summary in an academic study published in 2020 provides some estimates of small-dollar credit use in 2016 and 2017 (Table 5-2).<sup>12</sup> Estimated totals for cash installment loans, pawn loans, vehicle title loans and payday loans were about \$75 billion in these recent years, much less than other common forms of mainstream consumer lending. Amounts naturally are going to be smaller for “small-dollar” lending, but evidence also suggests that only a small fraction of the public uses these loans. According to the 2017 FDIC Unbanked-Underbanked Supplement to the Current Population Survey, 1.7 percent of households used payday loans, 1.4 percent used pawn loans, and 1.4 percent used automobile title loans. (This source does not report on traditional installment cash loans from finance companies.)

**TABLE 5-2: ESTIMATED DOLLARS BORROWED IN SMALL-DOLLAR LOANS 2016 AND 2017**

	2016	2017
<b>Dollars Borrowed (Billions)</b>		
Installment cash loans	18	20
Pawn transactions	14	14
Vehicle title loans	6	7
Payday loans (storefront)	20	18
Payday loans (online)	15	15
Total Small Dollar	74	73
<b>For Comparison</b>		
Credit card lending	415	406

<sup>12</sup>See J. Brandon Bolen, Gregory Ellihausen, and Thomas W. Miller, Jr., Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research, ECONOMIC INQUIRY, Table 1 (April 2020).

Automobile lending	591	595
Student loans	130	135

Source: Center for Financial Services Innovation (CFSI), December 2017 as reported by J. Brandon Bolen, Gregory Elliehausen, and Thomas W. Miller, Jr., “Do Consumers Need More Protection from Small-Dollar Lenders? Historical Evidence and a Roadmap for Future Research,” *Economic Inquiry*, April, 2020, Table 1. CFSI cites data from “Alternative Financial Services: Innovating to Meet Customer Needs in an Evolving Regulatory Framework” by John Hecht, Stephens, Inc. 2014, and statements by John Hecht for Jefferies, Inc., 2015–2016. In addition, for pawn, payday, and installment loans, CFSI estimates are based on publicly traded industry leaders’ annual and quarterly report data (2009–2017), market share data, and figures reported by the National Pawn Brokers Association. For payday, rollovers are counted as discrete volume. For Title lending CFSI estimates are based on state-specific title loan incidence, volume, and revenue data reported by regulatory agencies in CA, IL, NM, TN, TX, and VA (2009–2016 as available); 2016 Revenue Data from the Center for Responsible Lending “Payday and Car Title Lenders Drain \$8 Billion in fees Every Year,” (2017), footprint of auto title lending locations and proportion of states offering installment and single-payment models for all states where the practice is legal sourced from “Driven to Disaster: Car Title Lending and Its Impact on Consumers,” Center for Responsible Lending (2013); additional data on proportional use of installment and single-payment auto title sourced from “Payday and Auto Title Lending in Texas, Market Overview and Trends 2012–2015,” Texas Appleseed (2016). Rollovers counted as discrete volume. Data for credit card debt, automobile debt, and student loan debt is available from the Consumer Financial Protection Bureau at <https://www.consumerfinance.gov/data-research/consumer-credit-trends/>.

## Historical Review by the National Commission on Consumer Finance

In 1972, the National Commission on Consumer Finance devoted a considerable portion of its attention to policy issues surrounding small-dollar consumer credit. Beyond merely pointing them out and referring to past reform efforts in the small-dollar lending area, the NCCF undertook and sponsored new empirical studies and encouraged more. Significantly, the NCCF argued for removing barriers to competition in financial markets in order to guarantee that charges for credit would be as low as possible in all areas of credit granting, including this one and its variations. Over the intervening years, regulators and institutions have implemented favorable competitive changes, but controversy over lending costs and necessary revenues for small-dollar loans remains.

The NCCF began its discussion of interest rates with its Chapter 6 titled “Rate Ceilings.” The Commission described the two competing approaches over the millennia as “Free Rates” and “Decreed Rates.” Both date to antiquity almost four thousand years ago. The Commission pointed out that interest-rate history shows that rates have always fluctuated with supply and demand, and so there is always going to be potential for conflict over interest rates between economic conditions and laws governing permissible rates.

Interest-rate history is also a history of violations of laws decreeing rates and subterfuges around various prohibitions. There were laws regulating loans and lenders in the ancient Babylon of Hammurabi, with penalties for violations (records are in the British Museum to this day). Lenders in the Roman Forum were faced by interest-rate limitations (often ignored) as were potential medieval lenders. The NCCF pointed out how charitable lending institutions for the poor in the form of public pawn shops existed specifically as a way around rate limitations for small loans by at least the fifteenth century. Apparently, small money-emergencies arose even before there was much of a money economy. Interest-rate ceilings continued to exist in the western European countries that sent colonists to North America in the seventeenth century, and settlers from England brought the experience of ceilings with them to the colonies and the early United States.

England repealed its rate ceilings in the 1850s, but during the NCCF's time all states except New Hampshire and Massachusetts still had general rate ceilings (still known as "usury laws" using the Biblical and medieval term). As outlined above in Chapter 2, by the early twentieth century, most states had also created various exceptions to their usury laws for various kinds of consumer credit but without eliminating the concept of ceilings. These exceptions consisted of special rate provisions according to institutional class and credit type: for small consumer cash loans at finance companies with state licenses (licensed lenders or small loan companies); for various kinds of loans (with or without deposits) at banks, credit unions, and industrial banking companies ("Morris Plan" banks); and at other regulated small-dollar lenders like pawn shops.

In the early twentieth century states also began to control "time-price differentials" on purchase of goods and services using credit from retail outlets and dealers that were another way around usury laws. Most states created the various clarifications and exceptions to their usury laws to facilitate the flow of consumer credit. The NCCF noted the extent and variety of these arrangements with examples and called the result a "hodgepodge." The Commission was quite evidently concerned whether the range of exceptions to legal requirements at the time was sufficiently broad to permit generation of needed credit availability under the competitive conditions it saw as desirable. It clearly was concerned that the "hodgepodge" had created gaps and limited markets into pockets where competition would be insufficient to generate the lowest possible prices consistent with production costs for all amounts of credit.<sup>13</sup>

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<sup>13</sup>Chapter 2 of this Taskforce report discusses a bit more about how rate ceilings and restrictions on other credit terms at this time differed by institutional class of the lender and often prevented lenders in one class from offering a set of terms offered by another class of lenders. The NCCF and others in its time also commented on how the variety of rate ceilings and loan size limitations in force could produce gaps in credit availability at different loan sizes and even situations where high-cost providers might be permitted to make loans of certain sizes while low-cost providers might be prevented from doing so. There is further interesting discussion of these possibilities with a graph that shows how they can happen in DAVID H. ROGERS, CONSUMER BANKING IN NEW YORK, 117-21 (1974).

The Commission concluded its own historical review, seemingly indicating its frustration, by quoting from Sidney Homer's *History of Interest Rates* about how the controversy never seems to end (NCCF *Report*, p. 93):

The controversy did not end with the Reformation and the modification of Church doctrine. It continued and continues. It is now couched largely in terms of justice and expediency, laissez faire or economic controls, controlled rates (supposed to be low) versus free rates (supposed to be higher). ... The rate of interest in the twentieth-century is often limited by law. It is still a subject of controversy, not only among economists, but equally among politicians and economic groups. Some like it high; some like it low.

The Commission then turned to discussion of purposes of rate ceilings on consumer credit commonly given. The Commission found four and discussed each at some length. In this discussion, the Commission contended that varieties of reasons were still advanced domestically, despite absence of governmental ceilings in most other countries it examined. Debate over the wisdom of price controls continued into the 1970s during the high-interest rates of those years that rendered usury ceilings even more disruptive than was usually the case in the past. These concerns seem generally less important today than in the NCCF's time as rates have subsided generally, although disputes in the small-dollar area have continued.

The examination of usury ceilings was important to the Commission on account of its legislative charge to study and appraise "the adequacy of existing arrangements to provide consumer credit at reasonable rates" (Consumer Credit Protection Act 404(a)(1)). The Commission concluded that credit rationing arose from rate ceilings and also from insufficient competition in some parts of consumer credit markets caused by the inefficient system of interest-rate ceilings and various exceptions only for specific institutions.

The first possible purpose of ceilings discussed by the Commission was "to redress unequal bargaining power" (NCCF *Report*, p. 96). This was the idea that rates always rose to the ceiling and so ceilings were necessary to keep them from rising too far. The Commission showed that rates did not always rise to ceilings through its review of empirical evidence previously available and through extensive new rate surveys it undertook. Instead, the Commission found that rates generally did not rise to ceilings in mainstream consumer-credit markets "except when the price ceiling is set at or below the market rate for the particular form of credit placed under price control" (*Report*, p. 96). The latter area involved cash installment loans that were subject to relatively low rate ceilings relative to their production costs. These were the most important source of small-dollar loans at the time.

There generally does not appear to be much request today for ceilings in other areas. Such other areas include mainstream mortgage lending, automobile, home improvement, and credit-card

credit. Institutions establish rates based upon market conditions and competition in these areas. Rates on much of credit-card credit today also fluctuate with changes in an underlying market-rate index outside the institution's control. The Commission believed that Truth in Lending would continue to improve competitive conditions in these areas, which it appears to have done.

The Commission indicated a second reason sometimes given for favoring ceilings as “to avoid overburdening consumers with excessive debts” (*Report*, p. 99). The Commission contended that “the theory is sustainable if it can be shown that consumers who would pay rates above ceilings are those who would become overindebted” (*Report*, p. 99). Even then the Commission did not recommend the ceiling approach. Rather, ultimately it contended that it is the demand and supply for credit that determines the volume of debts, including the possibility of credit rationing by the suppliers.

The Commission maintained that it is not rate ceilings in some part of the market that accomplishes the task of limiting debts. Instead, excessive indebtedness springs from lending mistakes. To be sure, events subsequent to a loan can produce unfortunate outcomes to credit situations entered responsibly by both borrowers and lenders (that is, these intertemporal transactions are subject to risk of subsequent events). Sometimes other lending mistakes were made, but neither risk nor lending mistakes means that rate ceilings were necessary to prevent general overextensions of credit. The Commission contended that rate ceilings would instead merely produce a lowering of risk acceptance overall, with lowering of credit availability to riskier potential customers possibly in need of additional credit.

The Commission also cited a third reason sometimes advanced for ceilings, “to administer credit grantors as public utilities” (*Report*, p. 102). Not much is heard about this idea today, but it certainly is not dead. The Commission continued: “This approach recognizes that if consumers are to be served, rate ceilings must be high enough to permit credit grantors to earn an adequate rate of return on their invested capital” (p. 102). In other words, this approach would allow lenders to be able to operate on a “cost plus” basis. The Commission noted that this requires knowledge of production costs to generate cost-plus legal pricing, but that its real impact would be segmentation by risk class chosen making this approach “a self-fulfilling result of the risk class served” (p. 102).

The Commission pointed out that this approach would require “a rate commission that would have to specify in some manner the highest risk class of consumers that could and *should* (emphasis in original) be served by each credit grantor” (p. 102):

Unless the rate commission were then prepared to examine the validity of credit turn downs for each franchisee, credit grantors operating under a fixed rate ceiling could improve their profit margin by denying credit to riskier consumers and by not offering costly forms of

credit, such as small short-term loans. The establishment of credit standards; and appropriate prices for multifaceted credit arrangements and the enforcement of requirements that credit grantors meet any "justified" demands by consumers of widely varying credit standings pose dire problems for a ratemaking-commission governing franchised consumer credit grantors.

It seems that this concern would still exist if this approach were advanced today, but the NCCF also discussed some further "practical difficulties." One was cost measurement for multiproduct financial institutions like banks and proper allocation of joint costs. Another was the existence of extensive availability of retail-store and dealer credit at the time where charges for credit could easily be buried in the cost of goods. A further one was the highly mobile nature of lending assets. Mispricing by public rate authorities would not immediately eliminate the availability of electrical service while the electric utility company struggled for profitability. The nature of the fixed assets in electricity generation (generating plants and distribution infrastructure) could not easily be employed in different uses. This would not be true of highly-mobile lending assets that would quickly move to other uses.

The NCCF also discussed a fourth argument sometimes advanced as favoring rate ceilings and the "most compelling problem to be considered," namely "to assure that consumers pay fair rates for credit" (p. 103). Following its analysis, the Commission again concluded that this issue amounted to another label for the same problem: fair for whom? Again, the outcome (and societal value judgement) would depend on which *risk classes* of consumers the system would allow to obtain legal credit. Higher risk classes would simply be more costly to serve, and this was the crux of the problem. Charging them higher prices than others was offensive to some, but rate ceilings would preclude their obtaining credit. How to manage this dilemma becomes a societal problem.

The Commission recommended that governments reconsider the need for interest-rate ceilings and take available steps to improve competition in consumer credit markets generally. As also indicated in Chapter 2 above, many states made changes to their interest-rate regimes during and following the extremely high interest rate period surrounding the year 1980, and consumer-credit granting institutions are generally much more competitive today. These changes and the broad decline of interest rates since the early 1980s have tended to make interest-rate ceilings much less contentious in recent decades, except in the case of small-dollar credit.

On balance, the Commission appeared to favor permitting existence of smaller-dollar credit from commercial sources, as long as regulatory conditions provided a competitive marketplace (p. 149):

The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.

Evidence shows that even this hedged recommendation was controversial at the time, even within the Commission itself (see the exchange between commissioners Senator William Proxmire (pp. 220-30 and 263-4) and Professor Robert W. Johnson (pp. 243-62)). As indicated already in this Taskforce report, allowable rates on small amounts of credit remain controversial today, in at least the fourth millennium of this debate.

## Recent Developments

The NCCF discussed at some length the main kinds of small-dollar lenders in existence then, notably traditional cash installment lenders (then known as licensed lenders or small loan companies) and retail outlets. There also were pawn lenders that the Commission did not discuss. These credit sources still exist, but today there also are other small-dollar lenders, including whole new industries such as payday and automobile-title lenders. There is also a related depository-institution product referred to as overdraft protection or sometimes as “bounce protection.” Further, there also are rent-to-own outlets. Taken together, these lenders have arisen on account of credit rationing by low-rate lenders and they cater to a range of risks. All of them must contend with the fixed costs of lending that loom large per loan dollar on small amounts of risky credit extensions.

It seems that much of the criticism of small-dollar lending and lenders from ancient times to the delivery of the NCCF’s Report and beyond reflects the view that charges for credit use reflect in large part the attempt by lenders to take advantage of borrowers. In economic terms a situation of this sort would be called a “market failure” in that markets are not providing for the needs (demand) in the marketplace at the minimum price that covers costs and allows for exchange. In effect, some observers through history from the Bible through ancient credit codes and up to the NCCF and the present time have suggested that much of high-rate lending results from the present-bias of borrowers that allows for price gouging by unscrupulous lenders.

As discussed here in Chapters 3, 4, and this chapter, economic theory and empirical evidence have shown there is more to the story. Most credit use by individuals today arises from opportunities that provide benefits over time including a preferred consumption time pattern. Economic theory also suggests that small-dollar lending will arise in situations where willing borrowers are constrained by credit rationing of low-cost lenders to limit risk. Higher-rate



lenders will emerge, but if small amounts of credit to risky borrowers are involved, production costs per loan dollar are high. This means that prices at which market exchanges (lending) takes place will also be high.

Available empirical evidence is consistent with this theory, but some observers apparently still maintain the market-failure contention. For instance, in its 2017 rulemaking concerning “payday” lending, the Consumer Financial Protection Bureau argued that the desperate condition of payday borrowers indicated they would pay almost any price and that biases toward considering only the present prevented them from fully understanding the costs of payday loans, views supported by many commentators.

Existence of large numbers of small-dollar credit sources where allowed, however, does not suggest existence of a comprehensive market failure like monopoly power conditions that allow price gouging. Lending does not require large fixed investments such as electric power generating stations that permit scale economies and discourage market entry by others. There also are no patents or secret processes in lending. Barriers to entry are low, except in states that create regulatory barriers to entry. Available empirical evidence indicates that although the price charged for small-dollar loans is high in APR terms, those prices appear to be the result of high operating costs including high loss rates per loan dollar on small-dollar lending (see Chapter 4). As discussed further below in Chapter 8, there is no evidence of supranormal profits or rates of return for businesses operating in the small-dollar loan market<sup>14</sup>. Rather, it seems that where regulation permits market entry, lenders are readily willing and able to enter markets to equate demand with cost-based supply.

Likewise, evidence to be discussed suggests that there does not seem to be market failure due to absence of necessary consumer understanding or knowledge. To be sure, consumers do not necessarily know nor understand everything about lending institutions or loans perfectly. But they also do not necessarily need to know or understand everything about lending for most of them to act in their own interests, even if some do not. Further, Truth in Lending in effect since 1969 provides ready access to information on prices. Individuals also learn from their experiences and can also pass information on to family members and others. Information will be discussed further in the next section and in Chapter 7.

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<sup>14</sup>Lack of public data has precluded extensive study of profitability of payday lending, but available information suggests that returns in payday lending are not excessive. See Mark Flannery and Kathryn Samolyk, “Payday Lending: Do the Costs Justify the Price?” FDIC Center for Financial Research, Working Paper No. 2005-009, 2005; Paige Skiba & Jeremy Tobacman, The Profitability of Payday Loans (Unpublished manuscript 2007), available at <http://www.cplaacps.ca/english/reports/Vanderbilt%20Oxford%20profitability%20study%2012%2010%202007.pdf>; Aaron Huckstep, “Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?,” *Fordham Journal of Corporate and Financial Law*, Volume 12, 2007.

That credit sources are willing sometimes to compete on a non-price basis like preferred hours or greater convenience likewise does not imply market failure. Institutions may try to attract customers by many means, but this does not mean customers are unaware of cost differences. The National Commission on Consumer Finance showed that consumers were aware of differences among credit-providing institutions and the credit-cost alternatives that the market provides. The Commission called this “institutional knowledge” and discussed it on pp. 177-80 of the Commission’s *Report*. The Commission found that institutional knowledge extended well beyond knowledge only of the new Truth-in-Lending disclosures.<sup>15</sup> The NCCF also stressed the importance of expanding competition in the small-dollar area, and the landscape is much more competitive today. This enables institutions to compete in a variety of ways and borrowers to choose the ones they prefer. There is no evidence of a market failure on this basis either.

Further, although human nature seems like it has always been able to provide a supply of willing producers of sharp practices (for instance, history also suggests that need for codification of moral codes like the Ten Commandments and others also extend well into antiquity), there does not seem to be a failure of consumer protection in the lending area either. Consumer protection laws in the financial area are quite comprehensive at both state and federal levels. Some individuals may violate the laws, but this does not seem to be the norm. There also is substantial public enforcement. Rather than turning to shady lenders willing to evade or break laws, it is more likely today that constrained potential borrowers will simply move down the list of lenders to a less preferred (higher-cost) credit source if necessary.

But some observers still do not like laws that permit small-dollar credit with its high costs per loan dollar. Their opponents hold the opinion that overly-restrictive consumer-protection laws can have the unintended consequences of preventing consumers from doing what they want and need or even acting in their own best interest. Ultimately, this is at heart a difference of opinion on the proper role of government in society, also discussed further below. With all this background in mind, it is worth looking at evidence on modern small-dollar lending more closely.

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<sup>15</sup> See also THOMAS A. DURKIN AND GREGORY E. ELLIEHAUSEN, THE 1977 CONSUMER CREDIT SURVEY, Chapter 3 (1978).

## 5.3 Common Methods of Providing Small-Dollar Credit Today

Juster and Shay wrote about “primary” and “secondary” consumer lenders, but there actually are many kinds of consumer lenders in what amounts to a continuum in the risk acceptance and pricing dimensions rather than a simple dichotomy. On the low-risk, low-cost end of the lending spectrum, there are prime mortgage lenders, new-auto lenders, and premium credit-card issuers. There even are lenders to highly credit-worthy wealthy individuals purchasing expensive cars, boats, aircraft, and even country club memberships, art, and antiques who prefer not to liquidate other assets to purchase such luxuries.

Credit cards move a bit further out on the risk continuum. Many credit-card purchasers use card services merely for convenience in making payments, even large ones, and repay the amounts quickly upon presentation of the bill at the end of the billing cycle. Other card holders use them as a credit source for purchases of appliances, home furnishings, and home and auto repairs and do not necessarily pay the balance in full when the monthly bill arrives. Some individuals have two or more cards, one for facilitating routine transactions and one or more others used as source of revolving credit.

There even are subprime credit cards used by individuals with poor credit records. Some of them remain poor credit risks but there also are others who use the subprime cards to generate improvements in their credit records with the hope of moving more into the mainstream. And so credit cards are a transitional form on the risk/cost scale. There are many low-risk, mainstream users of credit cards but also some riskier and more costly users. Some users of higher-risk cards graduate to lower-risk credit sources while others do not or even move the other way.<sup>16</sup>

More recent evidence further shows, however, that card holding has fallen from a peak of about three quarters of households in 2001 (see Table 2-2 in Chapter 2), suggesting the possibility of unserved demand in this credit area. Beyond most credit-card credit on the risk scale are the true secondary lenders in the Juster-Shay sense, the high-risk, small-dollar lenders. Discussion

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<sup>16</sup>Research following implementation of the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the “CARD Act”) showed that about seven in ten individuals in the bottom quartile of credit bureau scores held bank credit cards in 2001, but that the proportion had declined to about half after by the time the CARD Act became effective in 2010 (also following the sharp recession of 2008-9). The research also showed an accompanying increase in cash loans at finance companies among nonprime consumers in states where rate ceilings permitted credit availability from this source. These findings show the apparent substitutability between credit card credit and traditional finance company loans (the latter at higher rates) as credit card credit became less widely available to subprime customers following implementation of the CARD Act and the recession. See Gregory Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, JOURNAL OF FINANCIAL INTERMEDIATION (April 2018).

of these other sorts of small-dollar credit has been widespread enough recently that today there are many existing descriptions of them ranging from journalistic reports to academic analyses.<sup>17</sup>

Basically, there are four main approaches to non-credit-card, small-dollar lending widely found today and a few others that should also be mentioned. Arrayed from lowest charge per loan dollar to the highest, the four main approaches are: traditional installment cash lending by finance companies at the lower-rate end, and then higher-rate, single payment pawn loans, auto-title loans, and “payday” loans. Some individuals also use forms of “overdraft protection” on deposit accounts for small-dollar credit needs, a source of short-term cash in some aspects like payday loans. These are the lenders and forms of lending that have caused much of the concern among some observers about consumer-credit use in recent years.

Two more credit sources on this end of the risk spectrum are the rent-to-own store and the buy-here-pay-here auto sales outlet. Very little about these latter sources is written in the economics literature. Even beyond them are the illegal lenders, typically still called “loan sharks,” that continue to exist according to news reports. They can range from small individual “entrepreneurs” to organized criminal enterprises, the latter especially not a favored research area among the academic community.

Academic and policy interest in other small-dollar lending in recent years means that a list of questions about such lending has developed. Some questions involve research matters and some are more oriented toward policy questions. Research questions include what is the evidence on outcomes of small-dollar loans and whether these borrowers seem to know what they are doing. Research in these areas is ongoing and quite apparently is not going to decide policy debates, but maybe it can inform them. Among the policy questions is concern over the proper role of government in making decisions for individuals. This is discussed in the next section of this chapter.

Looking first at the outcomes issue, Professor John P. Caskey of Swarthmore College articulated his “Big Question” concerning whether small-dollar loans “on net exacerbate or relieve customers’ financial difficulties.”<sup>18</sup> Most of the recent studies of small-dollar lending focus on payday lending and the payday results have been mixed on this question for them (discussed further below). This is partly due to differences in the specific questions analyzed by the payday studies but also to data and methodology differences (for instance, using aggregate statewide

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<sup>17</sup>For lengthier academic descriptions of these institutions and kinds of credit, see THOMAS W. MILLER, JR., *HOW DO SMALL-DOLLAR NONBANK LOANS WORK?* (2019) and Bolen et. al. (2020), *supra* note 12. See also Durkin, et al. (2014), *supra* note 3, Chapter 8.

<sup>18</sup>John P. Caskey, *Payday Lending: New Research and the Big Question* in PHILIP JEFFERSON, ED. OXFORD HANDBOOK OF THE ECONOMICS OF POVERTY (2012).

economic data versus surveys of individuals or findings from experimental designs). Ultimately underlying the research results is the inherent variability of outcomes from credit use (its risks), especially where high risk, high rate, single payment loans like payday loans to lower-income consumers are involved. Therefore, research findings do not reveal clear conclusions on Caskey's "Big Question" for all cases or allow easy generalizations.<sup>19</sup>

Overall, research findings on small-dollar lending show that having small amounts of credit available can mitigate costly contingencies ranging from overdraft fees, bounced-check fees, and late fees on unpaid rent and other bills to needs like emergency car repairs and unexpected medical bills. The correct underlying interpretation of the need for a short-term loan is illiquidity that has developed possibly for a combination of reasons.

Surveys show that consumers acknowledge a variety of immediate reasons needing immediate attention. For instance, surveys on payday-loan borrowers reported by the Pew Charitable Trusts found that 69 percent of payday loan users used such loans "to cover recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food; 16 percent dealt with unexpected expenses, such as a car repair, or emergency medical expense."<sup>20</sup> Studies also show that there also appear to be some individuals who exhibit behaviors involving small-dollar credit consistent with present-focused behavioral biases or time-inconsistent discounting of future incomes and spending. These also are hypothesized and sometimes identified by academic behavioral researchers using student subjects, but this is not the overarching reason for small-dollar credit use.

It also turns out that consumer decisions for many small-dollar loans do not require some sort of difficult financial mathematics for users to make informed decisions about potential outcomes. Reasons for using the credit typically are very immediate and clear: some sort of illiquidity. For instance, few things are clearer than emergency conditions or an immediate need with little or no cash available. The emergency is obvious and the cost of a loan is readily available and easy to ascertain, even if future outcomes can vary from expectations. Further and significantly, Truth-in-Lending requirements mandate cost disclosures both in dollars ("finance charges" in TIL terms) and as an Annual Percentage Rate. Even the skills of a certified financial analyst would not lead to different decision parameters in these situations: Often the short time period means that discounting the cash flows is little different from undiscounted cash flows.

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<sup>19</sup>Interestingly, evidence shows that low income and high risk on the basis of credit score are by no means perfectly correlated, see Rachael Beer, Felicia Ienescu, and Geng Li, *Are Income and Credit Scores Highly Correlated?*, FEDS NOTES (August 13, 2018). They are correlated to a degree, however, and even low-income individuals with high credit scores are going to exhaust their credit capacity more quickly than higher-income individuals with high scores, making them riskier for substantial amounts of mainstream credit from primary lenders.

<sup>20</sup>PEW CHARITABLE TRUSTS, *PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY* (2012).

Even at high rates, entering calculations of time value of money as a financial analyst might do would cause few analytical reversals of benefit/cost criteria or require sophisticated financial review.<sup>21</sup>

Survey evidence also shows that many users are aware of the main features of the loan products. For instance, evidence from a variety of surveys shows that borrowers typically understand the dollar-cost of the loans, also discussed further below. This means that users are easily aware of both the benefits and the cost and provides the context for use of the credit and its potential outcome. Unfortunately, looking closely at choices and outcomes for large numbers of specific individuals by researchers is generally not easily possible due to lack of much survey information on outcomes at the individual level. Research findings are discussed further in the following subsections on individual products.

## Traditional Installment Cash Lenders

Beginning with the lowest-rate source for small-dollar credit, one type of small-dollar lender still somewhat common today in some states is the traditional cash installment lender. This sort of lending is considerably older than payday and auto-title lending industries and has its own approach and heritage. Notably, the traditional small-loan industry makes loans with repayment over multiple months with repayment designed to fit into monthly budgets more smoothly than lump-sum repayment.

As indicated earlier in Chapter 2, small cash loans to individuals for household purposes became common in the United States in the years after the Civil War, mostly illegally at first. By the 1910s, abuses produced a public reform effort led by the Russell Sage Foundation and it conceived the regulated small-loan industry. In the past, these companies were known as licensed lenders, small loan companies, or consumer finance companies. In the states where it still exists, this industry today typically is called the traditional installment cash-loan industry to differentiate it from the other small-dollar lenders.

These lenders make relatively small cash loans to individuals for periods usually from six months to about two years with interest rate ceilings specified in state lending laws. Because of the unsecured nature of these loans and their longer maturities and slower payment schedules,

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<sup>21</sup>Textbooks on finance discuss the concept of time value of money and the role and methods of financial analysis in more detail. For discussion in the context of payday loans see GREGORY ELLIEHAUSEN AND EDWARD C. LAWRENCE, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND (Washington: Georgetown University Credit Research Center, Monograph Number 35, 2001), also summarized in Durkin, et al (2014), *supra* note 3, Chapter 8, 370-4.

the lenders evaluate the employment and budget condition of potential borrowers more carefully than the other small-dollar lenders (called “underwriting” the loans).

Typically, the allowed rate within states varies somewhat by loan size, with higher rates allowed on smaller loans in some states. Because the National Commission on Consumer Finance discussed them at length and since lending-cost data on these lenders exist, Chapter 4 of this Taskforce report examined cost aspects of their lending in more detail. Rate requirements on the smallest loan sizes for short terms and annualized under TIL rules can exceed 100 percent APR, but more typical are somewhat larger loans at considerably lower rates.

Traditional small cash installment loans occupy a middle ground between mainstream installment credit from banks and other primary lenders including credit cards and small single-payment loans like pawn and payday transactions. Traditional small installment loans are not the same as the other forms of small-dollar credit, despite how they are sometimes lumped together. Payday loans arose from the check-cashing industry as a “payday advance” procedure requiring single-payment payoff redemption. Pawn loans and title pawns have different heritages, but also have reflected the plan of a single-payment payoff within a short period of time. Evidence suggests that where laws still allow small-dollar versions of traditional installment cash loans to exist, lenders also supply them and demand finds them.

As indicated in Chapter 2 and here, traditional installment lending industry arose from the ultimate background of the reforms sponsored by the Russel Sage Foundation in the 1910s. At the time, the reforms allowed for exceptions to prevalent state rate ceilings on loans of \$300 and less that permitted small loans to be made with repayment in installments. Allowed rates varied according to state, but reached 42 percent on the smallest sizes in an early version from the Sage Foundation. Today, traditional installment cash lenders typically make small cash loans at the sorts of rates suggested as necessary by the NCCF in 1972 (see discussion in Chapter 4 above).

Statistical review in the previous chapter suggests that a ceiling of 42 percent today would not allow these lenders to engage in making such loans smaller than about \$2000 and still cover all costs (see Table 4-2 in the previous chapter). Thus, finance company installment loans at the larger end of the size spectrum are going to be more prevalent in states allowing rates at the lower end of the rate spectrum, as they were at the time when the Sage Foundation was lobbying its reforms. Today some states allow for sufficient rates on smaller loan sizes to permit lenders to make smaller loans, but lending laws that once encouraged this reform have atrophied in many places. This happens if limits on loan amounts permissible special (higher) rates do not keep pace with inflation.

An extreme hypothetical example can clarify this point: If in some state the loan size ceiling of \$300 at a 42 percent rate had not been raised above this size limit since 1916, there would be no

loans in this state today under this law. As the table in Chapter 4 shows, lenders would not be willing to make loans in this market below a size of about \$2000, but the legal size limit would not permit loans larger than \$300. Thus, there would be no lenders (and no loans) at the atrophied legal limits of \$300 and 42 percent in this state. Filling in a larger loan size limit in the example up to about \$2000 would produce the same result.

There has been only limited research on the traditional installment cash lending industry in recent years, mostly, like with other forms of small-dollar lending, because of lack of data such as surveys of borrowers. There is only limited information even about where such traditional installment lending takes place and in what volumes. At the time of the NCCF, much more information was available from state regulators. Some studies at the time used this available statewide data, and the NCCF undertook additional data gathering and research studies on this industry.<sup>22</sup>

More recently, Durkin, Elliehausen, and Hwang used information from a survey of traditional installment cash lenders undertaken by the American Financial Services Association to report characteristics of more than 3.1 million small-dollar traditional installment loans made in the second half of 2013.<sup>23</sup> They reported many of the key findings about these surveyed loans in a summary attached to their paper. Discussion included how these loans are found in states where rate ceilings on smaller loan sizes are similar to those the National Commission on Consumer Finance calculated in 1972 were necessary before such loans would be available. Few loans were found in states with lower ceilings (see their summary, pp. 2-3):

Findings from the AFSA survey of installment lenders are consistent with hypotheses developed many years ago from the economic theory of credit rationing. These hypotheses

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<sup>22</sup>A selection of economic, historical, and statistical studies of the installment cash lending industry available to the National Commission in 1971-2 included, among others: ARTHUR HAM, *THE CAMPAIGN AGAINST THE LOAN SHARK* (1912); Rolf Nugent, *Three Experiments with Small Loan Interest Rates*, *HARVARD BUSINESS REVIEW* (October 1933); LOUIS N. ROBINSON AND ROLF NUGENT, *THE REGULATION OF THE SMALL LOAN BUSINESS* (1935); THOMAS G. GIES, CEDRIC V. FRICKE, AND MARTHA SEGER, *CONSUMER FINANCE COMPANIES IN MICHIGAN* (Ann Arbor, MI: Bureau of Business Research, University of Michigan, 1961); Paul F. Smith, *Recent Trends in the Financial Position of Nine Major Consumer Finance Companies* in *THE CONSUMER FINANCE INDUSTRY: ITS COSTS AND REGULATION*, (eds. John M. Chapman and Robert P. Shay 1967); PAUL F. SMITH, *CONSUMER CREDIT COSTS 1949-1959* (1964); IRVING S. MICHELMAN, *CONSUMER FINANCE: A CASE HISTORY IN AMERICAN BUSINESS* (1970); JOHN M. CHAPMAN AND ROBERT P. SHAY, *LICENSED LENDING IN NEW YORK* (1971); and Thomas A. Durkin, *A High Rate Market for Consumer Loans: The Small Small Loan Industry in Texas*, *TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE*, Volume II, Number 3 (1973).

<sup>23</sup>Thomas A. Durkin, Gregory Elliehausen, and Min Hwang, *Rate Ceilings and the Distribution of Small-Dollar Installment Loans from Consumer Finance Companies: Results of a New Survey of Small-Dollar Cash Lenders*, (2014, available on Social Science Research Network). Before discussing their statistical findings about these loans, the authors further reviewed Juster and Shay's analysis of how credit rationing would likely involve lower income and younger consumers most often.



suggest that users of small dollar amounts of installment credit from secondary credit sources are “rationed” borrowers in an economic sense, those borrowers unable to obtain as much credit as they need or want from primary lenders at low rates. Specific findings include:

Most loans (more than 85 percent) clearly are subprime on the basis of credit scores. (Sixty-eight percent had credit scores below 620 and 24 percent were below 551).

These installment loans are both small and short term. Almost 75 percent of the surveyed loans are made for \$2000 or less and 77 percent for two years or less. These are precisely the loans the federal study commission [the NCCF] determined would require high rates.

High APRs are due to both small size and high risk.

Loans are made with low payments to satisfy both demand among rationed borrowers for small payments and supply by lenders who also are interested in easy repayment. Almost 40 percent of the loans have payments of \$100 or less monthly and almost 75 percent \$150 or less. ...

Durkin, Elliehausen, and Hwang also found that frequency of this lending varied sharply among states. States with low ceilings have few loans, larger average loan size, and longer maturities. The finding that states with low ceilings have larger average loan size is consistent with the hypothesis that where permitted rates are lower, borrowers and lenders will work toward adjusting terms. Adjustments tend to increase the principal amount borrowed in order to reduce the Annual Percentage Rate of the loan to come in under the legal rate ceiling. To keep payments manageable on larger loans, maturities could be lengthened, but these changes would result in higher costs (total finance charges) for the consumers, even at a lower APR. Durkin Elliehausen, and Hwang offer examples of these adjustments in their paper. Such larger and longer loans also would likely only be available to the better credit risks.

As previously discussed, (with examples) in Chapter 4, such adjustments that rate ceilings cause can be harmful to consumers desiring smaller loan amounts of credit. First, some higher-risk consumers who could qualify for a loan at a smaller principal amount will not be able to qualify at the larger minimum loan size. Second, adjusting to larger loans for a longer period can force higher total finance charges than if they were permitted to borrow only the amounts they needed. The National Commission on Consumer Finance and the Russell Sage Foundation before it understood this.

Durkin, Elliehausen, and Hwang provided examples. They found that in Pennsylvania, which has a low maximum permissible rate, there were few installment loans — just 1.5 per 1000 population. Moreover, there are almost no loans for less than \$500 and only 1 percent of loans

for under \$1000. Fifty-seven percent of loans had maturity lengths greater than two years. As a result of these larger loan amounts, 55 percent of loans had monthly payments in excess of \$150 per month.

The authors compared experience in Pennsylvania to Texas, which allows higher APRs on small installment loans. In Texas, there are many more loans — 23.9 per 1000 population. Forty-two percent of loans were for under \$500 and 70 percent were under \$1000. Finally, 99 percent of loans had maturity periods shorter than two years. Because of the smaller loan sizes, only 16 percent of borrowers had payment obligations of greater than \$150 per month. And smaller loans for shorter intervals reduce finance charges.

The authors also found that the delinquency rate in the survey of installment loans was high, with the highest slow-pay experience on the smallest loans sizes. Delinquency there ranged up to more than 25 percent, although undoubtedly many of these loans paid off, even if slowly and only after costly and time-consuming reminders. Borrowers with the lowest credit scores qualified for only the smallest loans.

In recent years, online installment lending of “payday-type” loans has also grown rapidly and should not be confused with “traditional” installment loans.<sup>24</sup> Although there is little systematic research of these newer payday-installment loans, available information suggests that these online installment loans are, on average, larger in size than those made by traditional storefront payday lenders, and have substantially higher rates of fraud and chargeoffs than such traditional storefront payday loans. Online borrowers also appear to have higher incomes than traditional storefront payday borrowers, consistent with the finding that they are also more likely to borrow larger sums.<sup>25</sup>

## Pawn Lenders

The oldest of the small-dollar lenders is the pawn lender, dating at least to the ancient Greek city states. In a pawn transaction, the borrower brings an item to the lender and leaves it there for a fixed length of time in exchange for current cash (the loan amount). Simultaneously, the borrower agrees to repay the loan in full with interest in a set amount of time (redeem the pawn), usually in a month, at which time the borrower receives back the pawned item. There is no true obligation actually to repay the loan and redeem the item, however. Instead, the

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<sup>24</sup>See Howard Beales and Armand Goel, *Small-Dollar Installment Loans: An Empirical Analysis*, Working paper (2015), available SSRN: <https://ssrn.com/abstract=2581667>.

<sup>25</sup>See G. Michael Flores, *The State of Short-Term, Online Lending*, BRETTON WOODS, INC., (2015).

borrower may simply walk away, in which case the pawn broker may sell the pawned item (or sometimes auction it if required by state law).

Explained this way, a pawn arrangement is a single transaction, a secured loan for one month. But it is also closely akin to and can be structured as two transactions: first a sale of the good by the individual to the pawn broker with agreement by the individual to buy it back later in a second transaction for a higher price. This sort of “lending” was done in the middle ages when true lending with interest was prohibited. The repurchase later at a higher price takes the place of returning the loan principal with interest. Robinson and Nugent (1935) reported that this sort of transaction was common in the “loan shark” period of domestic consumer credit before about 1910. At the time, a succession of such one month “loans” could extend the transaction for much longer than a month.<sup>26</sup>

Because this second possibility could potentially produce abusive situations even amounting to extortion by lenders holding on to the goods instead of allowing their timely return, state laws typically require that pawn-shop transactions be structured clearly. They must be either loans with specified terms, conditions, and requirements, including the lending period and maximum amount of finance charge, or true sales. Because pawned items often are not redeemed, however, ordinary pawn loans also often become sales to the lender (or auctions) to recover the loan amount and interest. In fact, a good way of thinking about a pawn loan is to think of it really as a sale for cash now (by the “borrower”) with the option to cancel the sale next month and get the item back by repaying the “loan.” Described this way it should not be surprising that “defaults” are relatively common: the “borrower” simply decides later to go through with the sale.

Because in some large sense pawn transactions are not really loans, pawn “lenders” rely on the value of the pawned item for security and do not investigate income or credit status of the “borrower.” Goods that are easily transportable, like jewelry, musical instruments, and electronic items, are common pawn offerings today. Typical maturity is one month with a common fee of twenty percent of the loan amount (annualized by Truth in Lending requirements as an Annual Percentage Rate (APR) of 240 percent). The pawn charge includes interest but also fees for secure storage of pawned pledges, since the pawnbroker is liable for damaged items and must provide storage space and facilities. There also are special regulatory requirements including records for law enforcement to prevent pawning or sale of stolen goods.

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<sup>26</sup>See ROBINSON AND NUGENT (1935), *supra* note 21.

There is not much recent research information on pawn lending, but there is some.<sup>27</sup> Concerning pawn borrowers, survey information suggests they are probably the weakest borrowers financially (Table 5-1). Casual industry commentary suggests that pawn lending frequently involves customers that would often not be of interest even to payday lenders due to risk. Bolen, Elliehausen, and Miller report much the same:<sup>28</sup>

Pawn borrowers are often in worse financial condition than those who use vehicle title loans or payday loans. They have lower incomes, more difficulty paying bills, and higher spending relative to income than vehicle title and payday borrowers. Pawn borrowers are also less likely to use auto loans, student loans, and credit cards than vehicle title and payday borrowers.

This worse financial condition than even other small-dollar credit users probably accounts for their use of pawn: As indicated, the pawn loan often amounts to the conditional sale of an asset owned by the borrower with a short-term *option* to buy it back in a month or so (presumably if conditions improve), by redeeming the item through paying off the pawn loan. Evidence also suggests that rate ceilings on pawn lending restrict the number of pawn shops and the amounts that lenders are willing to advance on pawn loans, although demographics are also important.

For many consumers, pawnbrokers are among the least-attractive options. In addition to being forced to pledge some item of personal property, the average size of pawn loans is much smaller than for other types of alternative lending, reflecting the reality that many of the items pawned are used consumer goods with modest resale value. Studies have found that the average size of a pawn transaction is only about \$70-\$80, a size of limited utility for meeting most financial obligations. Pawnbrokers are often patronized by consumers who do not have bank accounts, because many other types of small-dollar loans (such as payday loans and bank overdraft protection) require a bank account.

## Automobile Title Lenders

The third kind of small-dollar lending common today is the automobile title loan, sometimes called a “title pawn.” It actually is a new variation of pawn lending in recent decades. In this transaction, the borrower brings the legal title of an automobile or truck to the lender and

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<sup>27</sup>See Robert W. Johnson and Dixie P. Johnson, *Pawnbroking in the US: A Profile of Customers*, GEORGETOWN UNIVERSITY CREDIT RESEARCH CENTER, Monograph Number 34 (1998); Robert B. Avery and Kathryn A. Samolyk, *Payday Loans Versus Pawn Shops: The Effects of Loan Fee Limits on Household Use*, Social Science Research Network Working Paper, (2011), and Marieke Bos, Susan Payne Carter, and Paige Marta Skiba, *The Pawn Industry and Its Customers: The United States and Europe*, Law and Economics Working Paper 12-26, Vanderbilt University Law School (2012).

<sup>28</sup> Bolen et. al. (2020), *supra* note 12.

receives a short-term loan based on it. Necessity of holding clear title suggests that most title pawns are mostly going to involve older vehicles with no other loans and liens.

A few differences from the traditional pawn loan are evident: First, the borrower keeps possession of the vehicle and leaves only the ownership document with the lender. Second, this difference in possession makes the transaction more akin to a secured loan for the lender but with the physical item of security not in the lender's possession and highly mobile. This enhances lending risk, since in case of default the security is not readily available for sale or auction without a repossession-like undertaking. Rates of twenty percent per month (240 percent APR) also are common in title pawns, but typically involving larger loan amounts than traditional pawns.

Like other pawns, most title pawns are made for one month, with payment of principal and interest at the end of the month (renewals for an additional month or months often occur). Some loans are made allowing for a succession of payments until full repayment is achieved (known as "vehicle-title installment loans," and again not to be confused with traditional cash installment loans from finance companies). Multi-month loans at title-pawn rates are going to be more costly for the individual than a single-month loan of the same amount.

Like normal pawns of smaller items left with the pawn broker, it is possible to think of a title pawn as a conditional sale of the vehicle by the "borrower" with a monthly option to reclaim the sold vehicle for the sale price (the loan amount) plus an option fee (legally, the pawn interest). Again it is not too hard to imagine that "defaults" are going to be common: the "borrower" simply goes through with the sale by walking away from the transaction (i.e. "defaults").

Empirical evidence suggests that "defaults" are common on title pawns. Undoubtedly, some occur because the borrower would like the car back but cannot make the payment. Others likely occur because the borrower prefers to keep the sale price (loan amount) rather than keep the old car, especially if it needs repairs. This conveniently puts the burden of getting rid of an unwanted car onto the lender. In some cases the vehicle is not even worth repossessing for the lender and it becomes a complete loss to both "borrower" and "lender."

Title pawns tend to be larger than pawn loans or payday loans due to the motor vehicle used as collateral. In 2016 the CFPB reported from a large sample that median size was about \$700 with mean \$959 due to some loans being much larger.<sup>29</sup> Nonetheless, Hawkins found that 57 percent

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<sup>29</sup>CONSUMER FINANCIAL PROTECTION BUREAU, SINGLE-PAYMENT VEHICLE TITLE LENDING, 6 (May 2016).

of title pawn customers do not have banking relationships.<sup>30</sup> Industry sources report informally that many might be recent immigrants.

Some evidence suggests that a portion of title pawn lending involves short-term business loans. In a 2010 study Zywicki assigned title pawn borrowers to three classes: small business owners like landscapers who use their vehicles as a source of short-term working capital, moderate-income borrowers with poor credit histories, and low-income consumers with needs and credit problems.<sup>31</sup> Others examining other locations and circumstances have found borrowers with lower incomes and less evidence of business-related borrowing purposes. The nationally representative survey in 2015 referred to earlier in Table 5-1 found title pawn customers to be somewhat higher-income than payday and pawn customers with somewhat more use of mainstream consumer credit, but many still within the demographic categories where credit rationing is more likely (see Table 5-1 and sources).

Historically, both pawns and title pawns share the difficulty of payday loans that they are inherently single-payment loans, making full repayment after a short time period inherently difficult in some cases. This means that full repayment may sometimes take a while, leading to a sequence of monthly renewals for this while. Defaults also are common in both short and longer title lending, but, as indicated, some defaults and even automobile repossessions on title pawns really amount to sale of the pledged item to the lender after time to consider this possibility further. As indicated and like other pawns, a title pawn can act like a conditional sale to the title lender for the loan amount, with a (renewable) option to repurchase the car by paying off the loan later. It seems possible that the borrower would be more likely to let the car go and end the sequence of monthly options when a pawned vehicle suddenly needs some new (expensive) repair or attached equipment like tires.

Most cars that are pledged as collateral for a title loan are old; Hawkins found that the average car pledged was approximately 11.4 years old and had over 90,000 miles. He also reported that the majority of auto title loan customers own more than one car and virtually all title pawn customers have access to alternative transportation if they lose their car as part of the loan.<sup>32</sup> Owing to their age and condition, many defaults on auto title loans result from a major mechanical failure or major accident to the car. In fact, only about half of defaults result in repossession of the vehicle because following a major incident its value can be less than the cost

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<sup>30</sup>See Jim Hawkins (2012), *supra* note 9.

<sup>31</sup>Todd J. Zywicki, Consumer Use and Government Regulation of Title Pledge Lending, *LOYOLA CONSUMER LAW REVIEW*, No. 4 (2010).

<sup>32</sup>See Jim Hawkins (2012), *supra* note 9. Interestingly, almost 9 percent of auto title loan borrowers in the survey reported that if they lost their car they would simply buy another one.

of repossessing and reselling it.<sup>33</sup> According to one survey, 8.5 percent of title pawn customers report that they would be forced to sell the car if they were unable to obtain an auto title loan. That figure exceeds the percentage of borrowers who lose their vehicle to repossession for failure to pay, but those forced to sell their cars lose possession immediately and with certainty.<sup>34</sup>

Apparently to combat this rollover element of such lending that has been objectionable to some observers, and, presumably, in anticipation of a proposed CFPB rule with the potential effect of limiting short-term single-payment loans, the industry trend has been toward loans with multiple payments (title installment loans). Greater prevalence of loans repayable in multiple payments does not make such loans similar to traditional cash installment loans, however, since the payday, pawn, and title-pawn multiple-payment loans are made at much higher APRs. From the “lender’s” perspective, pawn and title pawn “loans” are not even dependent upon the income or cash flow of the borrower, but rather depend upon the value of the pawned item.

There has been a small amount of survey research on the experiences of title-loan customers, focusing especially on aspects of the decision process such as overconfidence about repayment ability with the planned time and time preference itself.<sup>35</sup> Because of data limitations it was not possible for the authors to provide definitive conclusions, but (like findings in the payday area examined next) they found evidence that many borrowers could make reasonable estimates of potential time to full payoff but with some evidence of present bias and a range of outcomes. They also found some evidence of learning about repayment times through experience. They found that about a fifth of borrowers were overtly present-biased in their estimation, but by no means everyone or even close to a majority.

## Payday Lenders

“Payday” loans are the fourth kind of small-dollar loan widely available and the newest basic type other than title pawns that really are a variation of older pawn lending. Payday lenders grew in recent decades out of the check-cashing industry. Check cashers developed to cash paychecks, for a fee, for workers who for one reason or another had no bank relationship for deposits or check cashing (or for whom common banking hours were inconvenient). It was only a small step to start “cashing” paychecks early for a somewhat larger fee. Due to a variety of regulations including Truth in Lending, such actions amounted to lending under state and federal laws. This would be controversial enough by itself, but annualizing these fees as required

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<sup>33</sup>See Todd J. Zywicki (2010), *supra* note 30.

<sup>34</sup> The Consumer Financial Protection Bureau reported a 3 percent repossession rate and Hawkins 4-6 percent.

<sup>35</sup>See Kathryn Fritzdixon, Jim Hawkins, and Paige Marta Skiba, *Dude, Where’s My Car Title: The Law, Behavior, and Economics of Title Lending Markets*, UNIVERSITY OF ILLINOIS LAW REVIEW (2014).

by TIL and then extending longer terms and providing rollover possibilities made them even more so. A fee of fifteen percent on a loan of two weeks is common (annualized under TIL rules as 391 percent APR).

Evidence shows that payday borrowers are overwhelmingly subprime with an average credit score of 520.<sup>36</sup> As discussed above, they lack current access to credit-card credit and many have searched extensively for credit elsewhere. Most do not have liquid savings available.

Recent tendencies in the payday loan industry include payday loans with repayments made in installments over time. While superficially such loans appear similar to traditional installment loans, installment payday loans are made under provisions of payday lending laws, at much higher TIL percentage rates and finance charges than traditional installment cash loans of the same size and maturity. Another more recent trend is toward making payday loans online over the Internet instead of only at storefronts. This approach contemplates making payday loans across state lines as well as locally. Available evidence suggests that online payday loans are the riskiest and highest-cost form of institutional consumer lending.

As indicated, most of the studies on outcomes of small-dollar credit in recent years involve payday lending. Using datasets not necessarily always originally designed to address questions on the impact of payday lending directly, studies over the past fifteen years have found usefulness of payday lending in reducing bounced checks and costly overdraft fees, Chapter 7 and 13 bankruptcy filings, and debt-collector harassment. One study found increases in Chapter 13 filings with payday lending but the authors also recognized that filings “depend on difficult-to-estimate parameters like private and social net costs of bankruptcy filings.”<sup>37</sup>

Some studies found favorable impact of availability of payday lending on other aspects of financial well-being defined in a variety of ways at the state level and other studies found little impact. There also are differences in findings concerning impact of payday lending on military preparedness using different definitions of preparedness and different data. The most recent study, using better data, concludes there is no evidence of a favorable impact on military preparedness of the ban on payday lending to the members of the military.<sup>38</sup> Some studies indicate that payday loans are a response to financial difficulties and not the proximate cause.

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<sup>36</sup>See Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman (2015), *supra* note 8.

<sup>37</sup>Paige Marta Skiba and Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default*, Vanderbilt Law and Economics Research Paper 08-33, 26 (2008). One problem with trying to determine the relationship of payday loans with financial distress is that it is not always clear whether high-cost loans are a cause or effect of distress. For instance, do they push a borrower into bankruptcy or are they the last resort in trying to avoid bankruptcy which is likely to occur anyway as a result of other conditions.

<sup>38</sup>Susan Payne Carter and William Skimmyhorn, *Much Ado about Nothing? New Evidence on the Effects of Payday Lending on Military Members*, REVIEW OF ECONOMICS AND STATISTICS (October, 2017).



Various studies have shown that payday borrowers typically do not have other credit available at the time of the loan.<sup>39</sup>

By themselves, these findings on balance appear to support the usefulness of payday lending in many situations, but they do not satisfactorily answer Caskey's Big Question: Even if findings were generalizable, there still is a significant range of possible outcomes at the individual level from highly favorable to highly unfavorable. This simply outlines the nature of the problem that financial regulators and legislators face, "a difficult trade-off between the benefits of regulation to households that make mistakes, and the costs of regulation to other financial market participants."<sup>40</sup>

Another line of investigation of payday lending has involved the implications of payday-lending heritage as single-payment loans payable a short period of time after the loan is made. This naturally raises the question how an individual who cannot pay for some emergency today is going to be able to make the payment a short while later, this time with an extra fee to cover the charges on the payday loan. An intervening paycheck is the answer, but what if that entire paycheck is already earmarked for other necessary expenditures (including payment of non-payday debts or other payday loans) or it is smaller than expected due to variations in employment hours of hourly workers, or even unavailable?

Analysts at the Consumer Financial Protection Bureau and elsewhere have examined this question and have attributed the frequency of renewals on payday loans as evidence of users' frequent inability to repay in full in single payments a short time later.<sup>41</sup> This is undoubtedly true in some cases, but some borrowers also do not extend their loans and many do appear to have understood this likelihood in advance.

Available evidence suggests many payday borrowers are aware of important information for making decisions. For instance, Elliehausen and Lawrence (2001) found that up to 98 percent of surveyed payday borrowers reported dollar costs of their loans that could be deemed accurate

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<sup>39</sup>For lengthier summary of these studies and detailed references, see Bolen et. al. (2020), *supra* note 12, 23-6, and Durkin, et al. (2014), *supra* note 3, Chapter 8, 386-94.

<sup>40</sup>John Y. Campbell, Restoring Rational Choice: The Challenge of Consumer Financial Regulation, *AMERICAN ECONOMIC REVIEW*, 25 (May, 2016). Immediately following this quotation is Campbell's concluding sentence: "The task for economists is to confront this trade-off explicitly, bringing to bear the highest quality evidence that modern applied microeconomics can make available." Reviewing available earlier studies on payday lending, Allcott, et al. raise the same point as Campbell in a new working paper in 2020 discussed further below: "Such analyses are difficult to use for welfare evaluation because it is not clear how to trade off effects on different outcomes or include other unmeasured welfare-relevant outcomes" (Allcott, et al., p. 5).

<sup>41</sup>See CONSUMER FINANCIAL PROTECTION BUREAU, PAYDAY LOANS AND DEPOSIT ADVANCE PRODUCTS (April 24, 2013); CONSUMER FINANCIAL PROTECTION BUREAU, CFPB DATA POINT: PAYDAY LENDING, (March 2014); PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA (Three reports, 2013); CENTER FOR RESPONSIBLE LENDING, THE STATE OF LENDING: PAYDAY LOANS (2013).

(precise measurement of accuracy would require availability of the loan documents, which the authors did not have). In contrast, they reported that only 20 percent of borrowers could report an accurate APR, although they indicated that most borrowers recalled receiving information on the APR. They concluded that borrowers considered the finance charge as the important indicator of the cost of the credit. In a study using an experimental design, Bertrand and Morse reached a similar conclusion in 2011.<sup>42</sup> This is not surprising since these loans are simple products with one price, a single finance charge at the outset (or at a rollover) compared to other loans that might have multiple components and fees.

The finding that the finance charge in dollars is an important concept to small-dollar borrowers actually considerably predates the beginnings of the payday loan industry. In other contexts, Due (1955), Juster and Shay (1964), and Durkin (1973) noted similar empirical findings.<sup>43</sup> These results suggest, reasonably, that the APR is not the only credit-price information that consumers may need or use to make credit decisions (also discussed here in Chapter 4). Congress understood this when it passed Truth in Lending in 1968, mandating disclosure of both the finance charge in dollars and the APR.

Before Truth in Lending, Wallace Mors (1965) had assessed the usefulness of various types of financial information and charges in a study for the National Bureau of Economic Research. He proposed that ideally consumers needed the dollar amount of finance charge, the size and number of monthly payments, and the annual effective finance rate (in TIL now known as the APR, functionally the annual unit price). He examined the use of these items in evaluating loan contracts having different loan amounts and terms to maturity. He concluded that none of the items can serve effectively as a single criterion, because each applies only to some aspect of the credit decision.<sup>44</sup>

Regarding small, short-term loans, he noted that annual finance rates are very high even when the dollar finance charges are nominal. As discussed here above in Chapter 4, this happens because largely fixed costs of acquisition and servicing are spread over a small amount of credit for a short maturity period. He further pointed out, as had Juster and Shay, that for evaluating loans of the same amount and maturity, finance charge, monthly payment, and APR are

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<sup>42</sup>See ELLIEHAUSEN and LAWRENCE (2001), *supra* note 20; and Marianne Bertrand and Adair Morse, *Information Disclosure, Cognitive Biases, and Payday Borrowing*, JOURNAL OF FINANCE (November 2011).

<sup>43</sup>Jean Mann Due, *Consumer Knowledge of Installment Credit Charges*, JOURNAL OF MARKETING (October 1955); JUSTER AND SHAY (1964), *supra* note 2; Durkin (1973), *supra* note 21.

<sup>44</sup>WALLACE MORS, CONSUMER CREDIT FINANCE CHARGES (New York: National Bureau of Economic Research, 1965). Mors also considered computational rates (used in mathematical computational formulas) in his analysis, but even before Truth in Lending using some kinds of underlying computational rates for disclosures was generally not legal unless they were also effective rates or specifically allowed by state law.

perfectly correlated. This means that in evaluating credit arrangements between and among lenders, focusing on the finance charge or the monthly payment amount also provides important information for comparisons in many cases.

Chapter 4 of this *Report* also noted briefly that on small-dollar loans the finance charge is also useful for another important comparative reason. Namely, when considering a short-term loan for a current need, the need or emergency is normally going to be very immediate and obvious. By examining the finance charge instead of the APR, the cost/benefit comparison of whether or not to employ the credit quickly becomes apparent as well. Hence, there is no surprise that those seeking such loans tend to focus more on the finance charge than the APR. This discussion is by no means intended to denigrate the importance of the APR but rather merely to refer back to Mors who pointed out before TIL that no single disclosure provides all the information about a credit arrangement. The finance charge, monthly payment, and APR serve different needs, but all are now required disclosures under TIL.<sup>45</sup>

Turning to another aspect of payday lending/borrowing, an interesting new paper by Allcott, et al. explored, among other things, whether payday loan borrowers correctly predict the amount of time it will take them to repay their payday loans, the rollover problem noted by the CFPB.<sup>46</sup> This is an important question for both consumer welfare and regulatory policy. If borrowers make accurate predictions of their repayment prospects (for instance, knowing that they will not be able to repay in full on the initial due date of the loan necessitating one or more renewals before repayment), then they can better estimate the complete costs and benefits of their payday loan than otherwise. If, in turn, they do not understand or predict the likelihood of renewals, then inability to repay and a cycle of unintended renewals can force borrowers into unexpected “debt traps” that, in addition to high APRs, are among the main complaints about the payday industry by advocates and various political figures.

In designing their study, Allcott, et al. had the advantage of reviewing and understanding earlier studies and how gaps in understanding this market had developed for lack of data and other

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<sup>45</sup> For a complete discussion of evaluating investments that provide benefits for the future including the theoretically correct way of using APRs to calculate net present values, see the well-known text on financial analysis by Bierman and Smidt (2006). Fortunately, since virtually all consumers will not find net present values either intuitive or easy to compute, APRs may also be used for unit-price comparisons of similar credit arrangements among creditors. Bierman and Smidt also note at the outset of their ninth edition that complex analyses are unnecessary for choices in which benefits are received in a short period: “If benefits are likely to accrue reasonably soon after the expenditure is made, and if both the expenditure and benefits can be measured in dollars, the analysis of the problem is more simple than if the expected benefits accrue over many years and there is considerable uncertainty as to the amount of these benefits,” see HAROLD BIERMAN, JR. AND SEYMOUR SMIDT, *THE CAPITAL BUDGETING DECISION: ECONOMIC ANALYSIS OF INVESTMENT DECISIONS*, 9th ed., 2 (2006).

<sup>46</sup>HUNT ALLCOTT, JOSHUA KIM, DMITRY TAUBINSKY, AND JONATHAN ZINMAN, ARE HIGH-INTEREST LOANS PREDATORY? THEORY AND EVIDENCE FROM PAYDAY LENDING (March 9, 2020).

reasons. For instance, they easily recognized that findings about whether borrowers understood what they wanted to do did not necessarily mean they *should* want to do it in the eyes of advocates and regulators. This encouraged a sophisticated research design by Allcott, et al. that connected such considerations as theory of life-cycle spending patterns, time value of money, risk aversion, and the potential bias of present focus or not of individual borrowers. They also surveyed and studied the relation of borrower experiences to the predictions of experts.

Data were specifically gathered for this project and involved a careful control-group experimental design (with a meaningful rewards component and size sufficient for statistical statements). As indicated, there were surveys of both borrowers and outside experts. Participation of a large payday lender allowed comparisons of experimental results with actual borrowing experience. The authors acknowledged that participation of only one lender could produce the complaint that customers might not be representative of all lenders and situations, but the project seems large enough to be importantly indicative, using forty-one separate payday storefronts.

Significantly, findings showed that borrowers predicted quite well the likelihood of reborrowing within a short period of time. This echoed the findings of Ronald Mann in a less-sophisticated and smaller pioneer study in this area some years earlier. Mann also found that most borrowers expected to extend the loan after the first period and predicted the final repayment date with some accuracy. He also found that errors made were in both directions and not just indicative of underestimating.<sup>47</sup>

Further, Allcott, et al. found that borrowers appeared to learn with experience, predicting better after previous experience, “more experienced borrowers predict exactly correctly on average” (p. 3). The authors argued that this experience component in prediction may suggest the reason why other, purely-experimental research designs, have found poorer predictive ability. They also reported that their panel of experts (including both academics and payday lenders) predicted considerably worse performance by borrowers in forecasting their payday loan payment patterns than predictions by payday borrowers themselves.

Although not the main focus of their work, the authors suggested that findings have implications for policy in this area. After not finding that behavioral biases of payday borrowers make them unable to predict future borrowing, the authors contended that outlawing payday lending lessens consumer welfare (p. 3):

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<sup>47</sup>Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, SUPREME COURT ECONOMIC REVIEW (2013).

We first provide theoretical propositions that give qualitative intuition for optimal policy. A payday loan ban can only harm time-consistent or sophisticated borrowers, as they correctly predict their future repayment when initially deciding how much to borrow. However, with limited uncertainty in repayment cost shocks, a ban benefits *persistently* naive borrowers, as they fall into “debt traps” where they continually reborrow because they falsely believe they will repay in the next period. If borrowers are *temporarily* naive and become sophisticated, as in our empirical estimates, the losses from overborrowing are tightly bounded, and a ban is again likely to be harmful [emphases in original].

As indicated, the authors noted that their results contrasted sharply with the prior beliefs of their panel of experts that contended that borrowers would be much more naive than they actually were.

## Overdraft Protection

Overdraft protection on depository accounts is a service similar in some ways to payday loans. Like payday loans, overdraft protection provides small amounts of credit for a short time to individuals with liquidity difficulties. Unlike payday loans, the individuals must be current customers of the specific bank or other depository institution that provides the overdraft protection, suggesting customers are not drawn from the very poor. Overdraft protection is provided by depository institutions like banks that hold the customers’ transaction accounts, but otherwise banks have never provided much small-dollar credit (except through credit cards), largely for cost, reputation, and regulatory reasons.

Under common overdraft protection plans, the bank or other depository agrees to cover overdrafts with a transfer of funds from another deposit account owned by the customer (like a savings account) or from a prearranged line of credit. There may be a fee for the transfer service.

But many potential users of overdraft protection do not have a savings account and also would not qualify for a line of credit and these options are not a practical possibility. Even in the absence of such prearrangements involving a transfer from another account or a line of credit, however, the depository and customer may arrange that the depository will honor debits from a debit card or ATM that cause an overdraft up to a certain amount, provided that the customer “opts in” to the arrangement.

Most users of this service view payday loans as the closest alternative product.<sup>48</sup> Both overdraft protection and payday loans are attractive to consumers with impaired credit and little or no

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<sup>48</sup>See Robert L. Clarke and Todd J. Zywicki, Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau, REVIEW OF BANKING AND FINANCIAL LAW (2013-2014).

further access to credit card or other loans but who have some urgent need for cash. Overdraft protection may be especially useful for point of sale transactions as it is far more convenient to access overdraft protection than a payday loan. Melzer and Morgan have found that in choosing between payday loans and bank overdraft protection, most consumers choose rationally, typically choosing the product that minimizes their overall costs of acquiring credit.<sup>49</sup>

In the situation of an overdraft that the depository covers, the fee for advancing funds for a time makes the arrangement look much like a short-term loan for a fee, but current rules make this sort of arrangement part of the deposit agreement and not a loan subject to Truth in Lending. Like payday loans and other forms of small-dollar credit noted above, overdraft protection can mitigate or obviate fees from illiquidity that can arise in other ways, including delinquency and late-payment fees on various bills and non-sufficient-funds (NSF) fees from dishonored overdrafts.

Much of the criticism of overdraft protection arises from the assessment of fees for covering shortages in deposit accounts. In recent experience, a fixed fee of around \$35 for covering a debit card or ATM overdraft is common. Unlike a payday or other loan with a specific loan amount for a fixed amount of time set by contract and where an APR can be calculated and disclosed in advance, an analogous APR for a specific overdraft-coverage event can only be calculated after the fact: As with a mainstream line of credit (including credit cards), the amount and timing are unknown in advance, making impossible the calculation of an APR conceptually the same as the APR on a closed-end loan like a payday loan.

Using assumed examples and experiences recorded on actual accounts, the CFPB and others, however, have calculated post-hoc APRs for these arrangements that exceed those on common payday loans. While such calculations are easy enough to make after the fact, it seems unlikely for the reasons discussed above that such APRs are as interesting or important to users as the actual charge of \$35. Even in individual cases where such charges are not fully contemplated or understood in advance, they probably are understood and remembered after the initial actual encounter. This undoubtedly helps explain recent growth of low-balance electronic alert services provided by the institutions using text messages. Nonetheless, “opt in” arrangements to overdraft protection are commonly offered by depositories and often used. That individuals and institutions have made such “opt in” arrangements is consistent with underlying neoclassical economic theory that debt use comes about from opportunities and necessities that provide net benefits to informed credit users.

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<sup>49</sup>Brian T. Melzer and Donald P. Morgan, Competition in a Consumer Loan Market: Payday Loans and Overdraft Credit, *JOURNAL OF FINANCIAL INTERMEDIATION*, (January 2015).

Even if such overdraft-protection advances are more expensive on an APR basis than payday loans, their convenience may still make them attractive to some people for managing liquidity shortages. Such circumstances include potential returned-check situations at merchants where a fee and possible ill will could be involved, or some other sort of emergency. The convenience of prearrangement compared to a payday loan would tend to make them competitive with payday loans, even if the cost is somewhat higher than a small payday loan. Neither of these sources of small-dollar credit is available to those without a depository account (the “unbanked”) who would still be restricted to credit sources like pawn lenders, specialized retail outlets, and individuals.

## Rent-to-Own Programs

Before concluding this section, it is worth also mentioning rent-to-own programs. Strictly speaking, rent-to-own transactions are not credit, but they serve as credit substitutes in some cases, and critics sometimes lump them together with small-dollar credit products. Rent-to-own transactions are actually rentals of household durable goods like furniture and appliances on a week-to-week or monthly basis but with automatic renewal until stopped. They sometimes are combined with small-dollar credit products because at some point the rental provider has received enough in payment and the property has aged and depreciated enough that it does not have much remaining resale value anyway. At this point, the provider simply hands over ownership to the lessee, hence, “rent-to-own” that providers heavily advertise as a possibility.

The arrangement differs from an installment purchase of the product, however, because the provider bears the ownership risks and costs during the rental period. These include delivery, set-up, repair, loaner service, refurbishing, and eventual re-rental or sale. The renter can return the product at the end of any rental period without early termination fee or further charge, except for damages. This avoids difficulties or costs associated with resale or disposal that might occur for owners.

With survey research in 2000, Lacko, McKernan, and Hastak found in a report for the Federal Trade Commission that about two thirds of rent-to-own users intended to purchase the item and about 70 percent actually did so.<sup>50</sup> Leaving aside the issue of how the costs of use (delivery, set-up, extended warranty, etc.) are not strictly comparable between rent-to-own and installment purchase, calculating an APR on a typical transaction as if it were the same as an installment

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<sup>50</sup>JAMES M. LACKO, SIGNE-MARY MCKERNAN, AND MANOJ HASTAK, SURVEY OF RENT-TO-OWN CUSTOMERS (Federal Trade Commission, 2000).

purchase reveals a high APR. A high APR on a relatively small transaction is why rent-to-own becomes lumped with small-dollar lending in many discussions.<sup>51</sup>

Lacko, McKernan, and Hastak also reported that three quarters of the survey respondents said they were satisfied with the transaction. They did not question respondents about costs, but responses to questions about satisfaction indicated that “many respondents were aware that the price was high.” Satisfied customers typically reported characteristics of the item being rented or services provided by the rent-to-own company as a reason for satisfaction. Few customers gave inadequate cost information as a reason for a poor evaluation.

Customer characteristics suggest that limited credit availability from other sources likely played a role in their decision to use rent-to-own. Available information suggests that rent-to-own users are comparable to pawn borrowers and are on average younger and lower income even than payday or auto-title borrowers and much younger and lower income than the population as a whole.<sup>52</sup>

## Illegal Lenders

For the obvious reason that too much inquisitiveness can be dangerous to health, academic researchers have tended to stay away from studying the illegal loan-shark industry, although on occasion research reports have arisen.<sup>53</sup> Much of what is known about illegal lending arises instead from criminal investigations that take place from time to time.<sup>54</sup> The worst aspect of illegal lending is how criminal enterprises have been known to engage in violence as part of collection activity, although the general belief among lenders apparently has been that too much violence is counterproductive by driving away potential customers from this market. News reports suggest it still exists, however.<sup>55</sup> It has even invaded popular culture through the

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<sup>51</sup>Durkin, et al. (2014), *supra* note 3, provide some APR calculations on their pages 366-7.

<sup>52</sup>Information on rent-to own customers is not available from the sources used in Table 5-1. Somewhat earlier comparative information, including from Lacko, McKernan, and Hastak for rent-to-own, is in Durkin, et al. (2014), *supra* note 3, Table 8.3, p. 375.

<sup>53</sup>See John M. Seidel, *Let's Compete with Loan Sharks*, HARVARD BUSINESS REVIEW, (May-June, 1970); Ronald Goldstock and Dan T. Coenen, *Controlling the Contemporary Loanshark, The Law of Illicit Lending and the Problem of Witness Fear*, CORNELL LAW REVIEW, (January, 1980); and David Baker and MacKenzie Breitenstein, *History Repeats Itself: Why Interest Rate Caps Pave the Way for the Return of the Loan Sharks*, BANKING LAW JOURNAL (2010).

<sup>54</sup>See, for example, NEW YORK STATE COMMISSION OF INVESTIGATIONS, *THE LOAN SHARK RACKET* (1965).

<sup>55</sup>See, for example, 22 Held in Staten Island Betting and Loan Sharking Raids, Associated Press, November 18, 2009; Dave Warner, Authorities Accuse 13 in Philadelphia of Mob Charges, Reuters, May 13, 2011; J. Roebuck, In Court 'Frankie the Fixer' Describes Collecting Loan-Sharking Debts, McClatchey Tribune Information Services, January 2, 2014. According to news reports, loan sharking is apparently of concern in parts of Europe, Asia, and Africa.



movies.<sup>56</sup> It seems unlikely that most individuals, even those down on their luck and without other available credit, would approach known criminal loan sharks today, but there have been many instances of doing so since at least the time of the Roman Empire.

In sum, it seems reasonable that more research findings on how individuals actually use small-dollar loans (or overdraft protection and rent-to-own) could help inform debate in the small-dollar area. Such research is expensive and uncommon, however, and even if undertaken more frequently seem destined not to settle in any sense the policy debate over small-dollar credit anyway.

For policy conclusions in the area of small-dollar loans, there still are tradeoffs to address. Economic theory and considerable empirical evidence suggests the usefulness of small-dollar loans, but not everyone agrees this is sufficient. For instance predictions by consumers of timing of full repayments of payday loans that are “exactly correctly on average” (Allcott, et al., p. 3) is a significant finding but not exactly the same as “exactly correct always.” The latter is, of course, an impossible standard, given contingencies, but this is not the same as saying it is not popular or wished for.

Further, findings show that some people are uninformed or are “present focused.” Also, risks unknown at the outset of a transaction sometimes can cause bad outcomes, even among the informed and rational. And small-dollar is the area of the highest cost (per loan dollar) and riskiest consumer credit. Finally, there is still also a contingent of observers who approve of wisdom perceived in Senator Proxmire’s contention in 1972 in the *Report* of the National Commission on Consumer Finance: “State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest” (p. 229). It seems he has not been the only observer with this view.

So, findings once again highlight the conundrum for legislators and regulators in this area: How to manage the tradeoff of denying availability of products like high-rate small-dollar loans that can help many users in appropriate situations but are high cost relative to loan dollars and some kinds may be difficult to repay in a short period of time. They also can sometimes harm individuals in situations of present bias. Such situations are less useful for enhancing welfare, and there are also the cases where credit simply does not work out well because of unfortunate contingencies that develop after the loan is made in good faith by both parties.

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<sup>56</sup>For instance in the early part of the original “Rocky” movie that won the 1976 academy award as Best Picture, the Rocky character played by Sylvester Stallone is employed as a loan shark collector/enforcer in Philadelphia. An actual convicted New York loan-sharking leader named Anthony Salerno was a main character in the 2019 movie “The Irishman.”

## 5.4 A Normative Concern

As noted at the outset of this chapter, small-dollar lending is a distinct market with some submarkets for different kinds of small-dollar loans, but discussion here shows that its economics is not unique. What is different about small-dollar lending involves the special conditions and constraints on consumers and providers in these markets, not their fundamental economics. There have been constraints on lenders throughout history (Chapter 2 above), but there still is demand for credit based upon its usefulness (Chapter 3), and supply is still determined by its costs (Chapter 4), even where the amounts are small.

As the foregoing shows, the basic characteristics of the small-dollar lending market are consistent with the predictions of neoclassical economics of consumer finance usage. Consumers who use small-dollar loans do so for the same reasons as consumers in mainstream credit markets: to take advantage of opportunities and mitigate costs of emergencies while changing the timing of the purchases to a preferred one.

But they do so under the distinctive condition of being *rationed* in credit availability. Many of them seek such credit at the state in their life cycle when demand for credit is highest but supply is lowest causing an imbalance. As a result, rationed consumers are unable to acquire all of the credit they demand from mainstream lenders and turn to secondary (higher cost) lenders, sometimes referred to as “fringe” lenders, to meet that demand. The prediction is that many borrowers using small-dollar lenders would be younger and more credit-constrained than those who use mainstream credit. This turns out to be an accurate prediction.

As shown in Chapter 4, the underlying cost structure of small-dollar loans suggests that the costs of making small dollar loans is expensive in both absolute and relative terms per loan dollar. This is inherent in the reality of relatively-fixed production costs: the cost of making loans does not scale proportionally with the size of the loan. Thus, the costs of small amounts of credit are high per loan dollar.

This interaction of supply and demand suggests that the equilibrium price per loan dollar for small-dollar loans will also be high. Moreover, there appears to be little reason to conclude that the actual prices that we see in the market are distorted by competitive issues or insufficient consumer protection. As history confirms, it is simply not possible simultaneously to control the price of small-dollar loans and still provide a supply that meets consumer demand. This is not a market failure but rather the perennial problem of how to provide small-dollar loans to wage earners at a price below that required by the market.

This reality has been long understood. So then why do we see repeated cycles of regulation and efforts to control prices and the supply and demand of small-dollar loan products? Apparently

the answer is that while many acknowledge these equilibrium conditions, they are also uncomfortable with this outcome.

For the Taskforce, this gives rise to something we characterize as our normative concern on this topic: whether society believes consumer credit availability for everyone is a good idea or not. Chapter 3 discussed the ageless economic motivations for the widespread phenomenon of consumer credit use today, how it provides the wherewithal to change spending timing and make large purchases and mitigate short-term emergencies that do not fit into family budgets. This mostly involves the kinds of purchases today that provide a return over time through vehicles, appliances, recreation and hobby items, repairs, modernization, and management of emergencies. The return comes about through acquiring the services they provide sooner than would otherwise be possible, avoiding purchasing less desirable (and often costly) substitutes in the meantime or doing without (and even “frittering away” the money). Such favorable outcomes can result from using mainstream forms of credit but also from employing less traditional smaller amounts. Nonetheless, there are difficulties here and all of this has remained a divisive area for centuries.

It seems that all observers some of the time and some observers all of the time today agree that credit availability is good for many individuals and should not be restricted from those who show evidence of ability to use it well. But some observers some or all of the time maintain that credit use is often too expensive (and possibly too dangerous) for at least some individuals. Some observers go farther still and recommend legal restrictions to protect the subset it may be dangerous for. Recently, it seems that at least some of the latter group have seized upon a developing new branch of economics referred to as “Behavioral Economics” that they believe supports this more-restrictive view. Many economists, including behavioral economists, disagree with this contention, as discussed further in the second half of Chapter 3. Instead, they contend that the motivations and evidence about using credit are much more fundamental than some behavioral biases identified by experimental researchers using student subjects in unreal settings that are not robust empirically with most consumer-credit uses.

But the Taskforce concludes that at its deepest level, whether or when to restrict credit use is not only a dispute in theoretical economics or about the worth of available empirical evidence. Evidence clearly shows that credit use is beneficial to most individuals in a wide range of situations, although undoubtedly with risks and sometimes with unfortunate outcomes. In this context it should not be surprising that studies of small-dollar credit use (in recent years, mostly concerning “payday” loans) find mixed results on questions of impact on overall consumer welfare. Sometimes these unfortunate outcomes are simply correlated with financial struggles, not the cause, as many of these products are last efforts to find a financial lifeline to stave off a descent into bankruptcy. Outcomes from credit use always vary among individuals, and probably vary most of all where small-dollar credit is involved due to the difficult financial

circumstances of the users. Even mortgages, credit cards, and other mainstream financial products have risks for consumers.

Certainly, differences in outcomes are going to exist. Economic theory and widespread empirical evidence clearly shows the advantages that can result from consumer-credit use, but difficulties that can develop are also well known. They include nonpayment, lawsuits, repossessions, and unfortunate, stressful collections at the worst possible time. These sorts of difficulties with credit can sometimes be seen clearly (with hindsight) when enough repayment ability was clearly not there, but they are mostly unforeseen for individuals at the outset of a credit transaction, developing only after unfortunate later contingencies. There also may occasionally be overreaching by certain institutional providers that can give consumer credit and its other providers a bad reputation. Some people may also be shortsighted. But the crux of the dispute goes deeper and does not seem resolvable by economic theories or empirical evidence about outcomes. Rather, it depends both on how observers evaluate the underlying tradeoff between potential rewards and risks of credit use and how they interpret their relationship to those caught up in this tradeoff, especially lower-income consumers. Sometimes existence of this tradeoff results in actions by governments.

In 1972, the National Commission on Consumer Finance addressed this tradeoff and came down on the side of encouraging credit availability by relaxing legal rate ceilings on small-dollar lending and promoting competition and consumer empowerment through information instead of imposing legal caps on prices. After discussing historical sources and reviewing studies and statistics, the NCCF wrote in its *Report* (p. 136):

The implications of these findings for public policy seem obvious: the only truly effective way of gaining ample supplies of personal loan credit for consumers *and* reasonable rates too, is to increase competition while simultaneously relaxing inordinately restrictive rate ceilings.

Not everyone agreed then (or now). Among many examples from many sources of the opposing view at the time, the opposing view is also found in the Commission's own *Report* especially in the "Separate Statement" of Commissioner and Senator William Proxmire, already quoted in part (NCCF *Report*, p. 229):

What the Report fails to recognize is that consumers are not nearly as sovereign as economic textbook theory would have us believe. ... The real choice is not between paternalism and no paternalism as the Commission report assumes. It is between business paternalism that is largely unaccountable to the public and responsible government policies. State governments have traditionally sought to protect consumers from the consequences of their own folly by limiting rates of interest.

Thus, whether credit use for all based upon their own judgements, and particularly small-dollar credit use, becomes a normative (philosophical or value-judgement) dispute over the propriety (and effectiveness) of government action in allowing sometimes costly or risky individual behaviors in a free society. Users of small amounts of credit potentially can benefit like anyone else but there are special costs and risks involved too. Small-dollar loans produce difficult examples for society of the potential benefits-cost-risk tradeoff inherent in any credit use.

This Taskforce realizes that it can provide, review, and update evidence on questions of the value of small-dollar credit use and its costs and problems (and even how some problems might be addressed). It also can recommend more research, but it cannot satisfactorily ever answer this normative question: whether society believes that credit availability is a good idea or not, including for those who want or need small amounts and only can qualify for small amounts. The hope is that its work will be helpful in clarifying these tradeoffs and debates, at least until the next commission or taskforce must address the same unending issues once again in some future decade. The ineluctable conclusion of centuries of historical and legal analysis is that small-dollar credit can be provided to higher-risk borrowers only at high cost or not at all.

Concerns over credit use today clearly are greatest in the area of small-dollar lending. For illustration, this is the last remaining bastion of binding domestic interest rate ceilings today and the one often suggested as in need of further extension.

By its nature, small dollar lending is going to involve individuals without much money, that is, without much discretionary income or liquid assets. Such individuals are not necessarily poor, but many are poor and down on their luck. Middle- and upper-income individuals are less likely to need small-dollar financing at all and if they do occasionally for convenience they can pull out their purses and wallets with their credit cards. And so the debate is going to center on these poorer and illiquid individuals.

Another underlying problem here is that by their nature, small-dollar loans at low rates do not generate much revenue for the lender to go with its costs, as discussed in the previous chapter. Application of the same interest rate to a smaller and smaller balance for the same length of time produces less and less revenue as the loan size shrinks. At some loan size, the revenue does not cover the costs of lending; and, in a capitalistic economy, below some breakeven loan size no (legal) lender from the private sector will make smaller loans.

One way out of the problem of credit availability for those in need of small-dollar amounts is to raise the interest rate or allow fees that amount to more interest on legal small loans. This was the approach favored by the progressive reformers of the Russell Sage Foundation in the 1910s to drive out the loan sharks. In 1972, the National Commission on Consumer Finance again explored the viability of this approach. Because it increases lending revenue and encourages

legal lenders to be willing to lend, the NCCF concluded it would improve credit availability usefully.

But many people since at least Biblical times (including Senator Proxmire in 1972, as noted twice above) have objected to this approach to lending over the decades and centuries. The reasoning is that the higher interest rate on small loans is perceived as taking advantage of the poor and those down on their luck and making repayment more difficult.<sup>57</sup> The NCCF wrestled with this question especially in Chapters 6-8 of its *Report* and we have to do so too (Chapter 4 and the present chapter). But we are fearful that this is not solely an economic or legal analytical question and that there is no satisfactory solution or recommendation that will satisfy everyone.

Poor and illiquid individuals' needing to pay higher rates for credit than middle-income and wealthier individuals who use larger amounts of credit has been unacceptable to many members of society for a long time. The result in many times and places has been governmental institution of rate ceilings on credit (called "usury" laws since the middle ages and actually much older). The outcome of these laws, in turn, has been unavailability of legally-allowed credit to affected individuals in many times and places since antiquity, notably in recent years domestically at the smaller loan sizes that do not generate much revenue. Sometimes charitable efforts or new institutions for government lending are offered as potential solutions. Others argue that insufficiency of charity and the general inefficiency of government compared to the private sector in any likely governmental approach to solving this problem weigh against these potential solutions. Even if this question is resolved, charitable or governmental lenders still must deal with the reality of operating costs, as do other worthy public ventures ranging from education to national parks.

Credit for everyone and especially for individuals with limited current resources involves the questions how significant is household credit use in the economy and why households might want to use credit in the first place (Chapters 2 and 3 of this report). Clearly it also involves costs of credit availability and how rationing can develop (Chapters 4 and 5). It also involves proper disclosures and competition (Chapters 7 and 8). But, as indicated, this discussion raises difficult questions that go beyond economics, law, and the institutions of lending that are the subjects of this Taskforce's efforts in any of these chapters. We note two components that society must resolve to answer the normative concern whether credit should be available for all and especially for those with limited means who need small amounts:

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<sup>57</sup>The cost of making small loans to consumers is discussed in Chapter 4. Since small loans typically are also of short maturity, they may actually not be as costly in dollars as larger loans made at lower rates, but they certainly can appear more costly on a rate basis, as also discussed in Chapter 4.

1. Is it proper for the government to decide who can obtain credit or not when there is a range of potential outcomes from good to bad, a subpart of the question what is the proper role of government in a free society? Although beyond the scope of any Commission or Taskforce on financial regulatory laws, this question naturally constantly impinges upon this Taskforce's efforts.
2. How can society solve the problem of poverty that raises most of the small-dollar lending concerns in the first place? This seems to be an even more serious and difficult question that has vexed human history since its beginning.

The National Commission on Consumer Finance was not oblivious to these concerns either and discussed them at some length in a mostly overlooked part of its *Report*. It is worth quoting at some length from this passage now (in its somewhat archaic original rendition) since this Taskforce recognizes the same issue (NCCF *Report*, Chapter 1, p. 2):

As Congress recognized, such an appraisal must begin (and end) with the issue of whether the industry provides adequate consumer credit to those who want it at reasonable rates. *Unfortunately, the Commission has been able to devise no empirical method for determining who should get credit, how much credit, what kind of credit, and at what price* [emphasis added].

It is questionable whether legislators want to begin making the intricate social judgements involved in designing laws to spell out who should get credit, how much, and at what rate. Most legislators attempt at all times to represent the best interests of their constituents. But their expertise is in the field of laws and statutes, not in rulemaking and regulations required to specify what part of a family's income could safely be devoted to monthly payments on credit obligations – given such variables as size of family, age of wage earners, nature of employment, and so on. This is the kind of activity the industry itself is constantly working on and attempting to improve by means of its credit scoring systems. The profit motive should be strong enough in our economy to assure that credit grantors will try to make as much credit available 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.

This does not mean that there is no role for the legislator in the area of consumer credit. There are critical functions – namely: (1) to promote and assure the maintenance of what the Commission deems to be the key ingredient of a finance industry capable of providing an adequate supply of credit at reasonable rates – competition among numerous alternative sources of credit; (2) to assure access *by all* [emphasis in original] to those alternative sources of credit; and (3) to prevent excesses which the system may provoke against the borrower.

Not specifically mentioned by the Commission, but certainly present in its overall tone, is the recognition that not everyone is going to agree with the worth of outcomes that the market system provides by itself in individual situations subject to risk. This Taskforce can agree, or not, with the findings and wisdom of the Russell Sage Foundation or the earlier Commission, but no financial study group can empirically satisfy remaining disagreements about the role of government in society and the solution to the problems of poverty. Neither, it seems, can it design legislative recommendations in these financial areas that satisfy all observers all of the time.

## 5.5 Conclusion: Insolubility of the Concern

And so, what is the answer? In the previous section we raised the question ultimately, whether society believes that consumer credit availability for everyone is a good idea or not. Since the beginning of recorded history and probably much longer, individuals have faced situations where more current resources would be useful, particularly in early life-cycle stages where demand for assets is high and available resources often low. Theory and evidence shows there are benefits to using credit in mainstream situations. These occur when acquiring assets that provide a positive return over time in the form of housing, transportation, education and better employment prospects, preferred recreational possibilities such as with boats and motor homes, and periodic mitigation of emergencies. Some credit use may indicate recklessness and impatience, but evidence suggests this aspect of credit use is less important than sometimes believed. All credit use is subject to risks of variable outcomes, including unfortunate ones not foreseeable in advance.

Some borrowers face additional difficulties due to lower or more variable incomes, more credit already outstanding relative to ability to repay, limited liquid assets, and underlying greater risks. Often such individuals are rationed, in that they are unable to obtain as much credit as they would otherwise prefer at the lending rates of primary (low-rate) lenders. Thus, they face the additional problem of needing small amounts of credit that operating costs and risks make more expensive on a rate basis.

This leaves stark tradeoffs in the marketplace and also among policy makers. Most observers believe today that availability of mainstream consumer credit is worth the risks that it entails, but the policy tradeoff problem is greatest where small dollars of credit are involved. There is little doubt that such lending is more costly per loan dollar than mainstream consumer credit.

All this then raises the issue of the role of government in society where these tradeoffs are concerned. Should government in a free society allow small-dollar loans or prevent them? Specifically, how can markets satisfy everyone that small-dollar credit is properly available to



those who need it while not charging them more per credit dollar for the costs and risks involved? More generally, how can their needs for small amounts of credit be eliminated? Ultimately, such needs are poverty-based. History shows that no government favors poverty and also that none has been able to eliminate it, regardless of political choices or system. And so, the question of the proper role of government on more-limited issues like small-dollar lending remains unsettled.

The Russel Sage Foundation and the National Commission on Consumer Finance proposed possible answers in this area (actually the same answer). Both were controversial in their times. There is no gain for this Taskforce to propose the same, or any other, solution to this question and to proclaim it now as the Big Answer, although it should be reexamined and we think the discussion here can help.

There always are, and always going to be, tradeoffs of potential gains and losses to be considered concerning credit use by individuals, the ongoing conundrum for legislators and regulators in this area. It seems, unfortunately, that any proposal or potential answer is going to be controversial in the same old ways, like any difficult question. The Taskforce urges more rational and fact-based discussion. And, like the National Commission on Consumer Finance before it, this Taskforce recommends and urges further research and discussion of facts to characterize the debate. This would be much more useful than merely further recycling of the tired old arguments and slogans of the past (like knee-jerk characterizing all small-dollar lending as either “beneficial” or “predatory” without reviewing and understanding the facts). Complaints and arguments have ranged from religious prohibitions to value-judgement musings, some of them now well into at least the fourth millennium of their time. Now is the time for something new, like reasonable discussion of tradeoffs and the possibility of reasonable compromise on an important policy question.

## 6. Consumer financial protection principles

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

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

This chapter focuses on the question of consumer protection. It is a propitious time to review the consumer protection regime with respect to financial services. In the fifty years since the NCCF Report, there have been profound changes to the federal consumer financial protection ecosystem. From the modest beginnings with the Truth in Lending Act (TILA) in the late 1960s, numerous laws and regulations have been layered atop each other. Interstate branch banking has been legalized, and credit card interest rates and other price terms have largely been deregulated. At the time of the NCCF Report, general purpose credit cards were a relatively new product, and the consumer finance economy was becoming increasingly national in scope and operation; today, consumer payments, lending, and other transactions are increasingly conducted over the internet. Technological innovation has created both new opportunities for consumer benefits but also potential new dangers, a trend that was accelerated by the COVID-19 pandemic. Banking

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<sup>1</sup> Report of The National Commission on Consumer Finance, *Consumer Credit in the United States* 2 (Dec. 1972).

crises in the 1980s and 2000s, both rooted in residential mortgage markets, spawned large-scale regulatory reforms. And in 2008 the world experienced a financial meltdown related to residential mortgages that raised calls for new regulations and new regulatory institutions. 2020 marked the tenth anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that established the Consumer Financial Protection Bureau (CFPB or Bureau).

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

## 6.1 Historical Background: State and Federal Regulation

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

As a historic matter, the federal government had a minimal direct role in consumer financial protection for most consumers and most products for most of American history. The federal role was not nonexistent, but its consumer protection function was largely a byproduct of its supervisory authority over federally chartered depository institutions and savings and loans. Where the federal government used substantive controls on consumer financial products such as

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<sup>2</sup> Usury regulations and their impact on consumers are discussed in greater detail in chapters 5 and 10.

maximum interest rates on savings accounts, it was usually to promote certain economic or other policy goals, such as controlling interest rates, initially to subsidize wartime financing during World War II, but then continuing interest rate controls after the war to promote the housing market, and still later as a complement to monetary policy efforts to control inflation. The Federal Trade Commission (FTC) also enforced federal law against unfair and deceptive acts and practices involving consumer financial services. The federal government's role in consumer financial protection expanded beginning in the 1960s and has grown dramatically since that time.<sup>3</sup>

Government regulation of consumer financial products and services is as old as credit itself.<sup>4</sup> The primary focus of consumer credit regulations was the imposition of price ceilings on the interest rate that could be charged on loans, historically known as “usury” ceilings. Many states also imposed limitations on the remedies available to creditors in the event of the debtor's default.<sup>5</sup> For example, many states abolished imprisonment for debt during the first half of the 19th century. Often the two elements would go together, as stricter interest rate ceilings often were associated with more lenient regulation of remedies that were available to creditors upon default.

Economists have long been critical of usury ceilings, dating at least to Jeremy Bentham's famous tract, *In Defense of Usury*.<sup>6</sup> By the time of the NCCF, the expert consensus was that despite the historic ubiquity of usury ceilings and other substantive regulations through history, the costs of those restrictions substantially exceeded the benefits for consumers and the economy.<sup>7</sup> Moreover, it was recognized that those costs fell most heavily on lower-income and higher-risk consumers, who were forced to pay higher prices for the goods that they purchased, had access to less competitive credit markets, and in at least some instances, were forced into the hands of illegal loan sharks. Paul Samuelson, the first American to be awarded the Nobel Prize in Economics, testified before the Massachusetts State Legislature in 1969 in arguing for the elimination of usury ceilings on consumer credit:

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<sup>3</sup> An extensive discussion of the history of state and federal regulation is available in Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd Zywicki, *Consumer Credit and the American Economy* (2014), especially chapters 10 and 11.

<sup>4</sup> For example, the Code of Hammurabi (1750 BC) included limits on the interest rate that could be charged on loans. See Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* 483 (2014).

<sup>5</sup> For example, in addition to limiting interest rates, the Code of Hammurabi also placed limits on creditor's remedies. Many traditional remedies were barbaric compared to what are currently known as remedies for default. *Id.* at 484.

<sup>6</sup> See, e.g., Jeremy Bentham, *In Defense of Usury* (1818).

<sup>7</sup> The underlying economic analysis of usury regulations is discussed in detail in chapters 5 and 10 of this Report. The brief discussion here is designed to illuminate the intellectual context that shaped the NCCF's deliberations and research efforts.

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.<sup>8</sup>

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

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

### 6.1.1 The Evolution of Federal Regulation

At the same time that evolving economic trends were exposing the costs of substantive regulation, the post-war American economy was becoming increasingly national in scope, fueled by falling transportation and communication costs. As discussed in Chapter 3, the post-war prosperity and great migration of Americans to the suburbs in the post-war era fueled an explosion of demand for automobiles, furniture, appliances, and other consumer durables, which in turn fueled a rapid increase in demand for consumer credit. The American population grew and became more mobile. Interstate migration and technological improvements that enabled financial products to be offered across state lines more easily (such as declining long-distance telephone rates) also made the consumer finance market more national in scope. Regional and national department store chains grew, with retail operations in multiple states.<sup>10</sup> As those

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<sup>8</sup> 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).

<sup>9</sup> Milton Friedman, *In Defense of Usury*, Newsweek (Apr. 6, 1970).

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

regional and national chains grew, merging with or eliminating smaller rivals, those chains centralized their credit operations in their headquarters while operating under the rules of multiple states.<sup>11</sup>

In the decades following World War II, banks were limited by branching restrictions from expanding beyond their home state. Beginning in the 1950s and expanding into the 1960s, however, bank-issued credit card became more widespread, growing primarily through the mail and telephone, not through a traditional bank branch network.

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

The interstate nature of these developments challenged traditional state-based jurisdictional boundaries, giving rise to increasing calls for a larger federal role in consumer financial protection. But at the same time, the growing consensus on the baleful effects of usury and similar regulations on consumers and the economy generated calls for a “fundamentally new approach” to consumer financial protection focused on “extensive required disclosures to consumer[s] of transaction-specific information” in place of substantive controls on product design and terms.<sup>14</sup> To be sure, many states also had disclosure laws of one form or another that

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

<sup>12</sup> See Todd J. Zywicki, *The Law and Economics of Debt Collection and Its Regulation*, 28 *Loyola Consumer L. J.* 167 (2016).

<sup>13</sup> See Hunt, *supra* note 10; see also chapter 11 of this Report.

<sup>14</sup> Durkin, et al., *Consumer Credit*, *supra* note 3, at 453.

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

As crystallized in the NCCF’s Report, which represented the consensus view at the time, the organizing principles of the modern consumer credit regulatory system was founded on the principle of robust competition and consumer choice as the first goal of consumer financial protection, and the primary focus of regulation should be to make markets work better for consumers by increasing transparency, competition, and consumer choice. The enactment of the TILA in 1968 marked the beginning of a new era of disclosure-based regulation that focuses on providing consumers with relevant information that will enable them to make better decisions and promote robust competition and consumer choice. Several similar regulations followed later, such as the Truth in Leasing Act in 1976 (implemented by Regulation M) and Truth in Savings Act in 1991 (with Regulation DD). A defining characteristic of new federal regulation was growing skepticism of substantive controls on terms and product design, such as price controls on interest rates and other terms and conditions of consumer financial products. In addition, new substantive legislation and regulation was enacted where there was a perception that markets failed to work fairly and efficiently, and information-based and existing state regulation were inadequate to address those problems. This second category included areas such as discrimination (the Equal Credit Opportunity Act and Fair Housing Act), where it was perceived that market processes had failed to adequately eliminate discriminatory practices, and various regulations on credit reporting (the Fair Credit Reporting Act), debt collection (Fair Debt Collection Practices Act (FDCPA)), and other markets where market incentives and constraints were not fully aligned to promote consumer welfare through competition and thus information-based remedies would be inadequate to fully remediate and prevent harms. Many of these substantive regulations also had disclosure remedies attached to them designed to enable consumers to also take steps to protect themselves.

As the NCCF observed, the logic of usury ceilings and other substantive regulation of terms and conditions of financial products fundamentally rests on the idea that politicians can determine better than the free interaction of consumers and financial service providers operating in competitive markets “who should get credit, how much credit, what kind of credit, and at what

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<sup>15</sup> See NCCF Report, *supra* note 1, at 170–71 (discussing state predecessors).

<sup>16</sup> Durkin, et al., Consumer Credit, *supra* note 3, at 453.

price.”<sup>17</sup> The Commission concluded that it could “devise no empirical method”<sup>18</sup> for answering those questions any more than it could establish whether the “price of a hamburger or shoes was ‘fair’ at any given time, or that more of either might be better.”<sup>19</sup> To answer those questions throughout the rest of the economy:

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

The NCCF’s criticism of traditional state regulatory approaches was severe and unflinching, noting that state legislation “tended to restrain competition and unnecessarily segment the consumer credit market” and noting numerous examples such as “unrealistic rate structures” and limits on the products that particular types of entities could offer to consumers.

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

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

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

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

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<sup>17</sup> NCCF Report, *supra* note 1, at 2.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 3.

<sup>20</sup> *Id.* at 3

<sup>21</sup> NCCF Report, *supra* note 1, at 2.



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

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

The world around consumer finance has changed dramatically in the past fifty years. Nevertheless, the current Taskforce enthusiastically endorses and recognizes the continued centrality of these four goals as the foundation of a well-functioning consumer financial protection system. To this list the Taskforce adds a fifth goal—the need to maintain an adaptable and flexible institutional framework that will enable the consumer financial protection regulatory regime to adapt more swiftly and effectively to changes in the consumer finance landscape<sup>23</sup>. Indeed, Part II of this Report comprising Chapters 6-10, will follow this analytical structure. This chapter discusses principles of consumer protection to protect consumers from “market excesses” and other market failures. Chapter 7 will focus on the importance and limits of information and disclosure-based approaches for making markets work more effectively, and lessons learned from the experience with disclosure regulation since the enactment of TILA. Chapter 8 will turn to the competitive landscape of consumer financial services, and as with the NCCF Report, focuses on proposals for making competition work better and clearing away existing barriers to competition. Chapter 9 examines the particular role of innovation in promoting competition, consumer choice, and inclusion. Chapter 10 will turn to the principle of access and inclusion. Later, Chapter 13 will provide an overview of the consumer financial protection institutional landscape and ideas for reform and modernization designed to improve its flexibility and adaptability to rapidly changing circumstances in the digital age.

The first major foray of the federal government into the realm of consumer financial protection approximately fifty years ago was driven by the growing difficulties associated with the traditional system of substantive regulation of terms and conditions of credit and the growing difficulties confronting state regulators in an increasingly national consumer finance economy. Today that problem has grown multifold as a result of the internet—not only is the economy national in scope, it is global. Even federal jurisdiction finds itself challenged to keep up with

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<sup>22</sup> Id.

<sup>23</sup> This will be discussed in chapter 13.

increasingly novel products and delivery mechanisms of the modern financial system. But while these innovations provide great promise for consumers, they also potentially raise new concerns, or in some instances, perceived concerns.

What should be the role and function of consumer financial protection in the 21st century?

## 6.1.2 Dodd-Frank, the CFPB, and the Principles of a Modern Federal Consumer Financial Protection System

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

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

The NCCF also called for the federal government to take the lead in modernizing state laws that interfered with competition and consumer access. To further the goals of promoting consumer protection, competition, and financial inclusion, the NCCF recommended that if the states would

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<sup>24</sup> See NCCF Report, *supra* note 1, at 58.

<sup>25</sup> See *id.* at 59.

not willingly remove usury restrictions and barriers to competition that harmed consumers and interfered with financial inclusion, federal action should be considered to preempt those laws. The Report states:

Finally, the Commission fails to see why every citizen of the United States is not entitled to qualify for participation in some part of the credit system herein advocated. It can find no validity in the proposition that when the legislature of a particular state refuses to move away from anachronistic notions, its citizens should suffer deprivation of credit afforded others of equal standing. Accordingly, the commission urges as its first choice the adoption of state laws 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.<sup>26</sup>

In addition, the NCCF stated, "If barriers to competition in the consumer credit market are not eliminated, federally chartered finance companies should be established utilizing the BCC as the chartering and supervisory agency."<sup>27</sup> Among the benefits of the federal charter identified by the NCCF was the ability to override archaic state usury ceilings and state "convenience and advantage" laws that erected barriers to entry against new competitors. Despite the NCCF's hope that states would phase out their usury laws on their own, state laws remain a patchwork of rules and exceptions and many states retain usury laws for many consumer financial products.<sup>28</sup>

Thus, the idea of a federal regulatory body charged with a consumer financial protection mission was put forward long before the Bureau was created in the wake of the 2008 financial crisis. Notably, the NCCF's first choice was the creation of a general federal consumer financial protection agency that contained a bureau of consumer credit within it.<sup>29</sup> Like the NCCF's proposed agency, the CFPB is charged with a multi-pronged mission of protecting consumers from improper practices and discrimination, developing rules for the provision of information to

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<sup>26</sup> *Id.* at 4.

<sup>27</sup> *Id.* at 59.

<sup>28</sup> It is difficult to find a general summation of usury regulations. For one recent effort to collect and summarize state usury laws for small dollar loans in a simplified format, see [https://www.nclc.org/images/pdf/high\\_cost\\_small\\_loans/payday\\_loans/FactSheet-StateRateCap.pdf](https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/FactSheet-StateRateCap.pdf); see also [https://www.cuna.org/uploadedFiles/Advocacy/Priorities/State\\_Government\\_Affairs/a-z\\_usury\\_lawguide.pdf](https://www.cuna.org/uploadedFiles/Advocacy/Priorities/State_Government_Affairs/a-z_usury_lawguide.pdf) (more extensive treatment of state usury laws).

<sup>29</sup> This resembles proposals that would have done what Congress did with the creation of the CFPB, namely to collect all consumer financial protection authority within one federal agency, but not to create an agency dedicated to *just* consumer financial protection but for consumer protection more generally. See, e.g., Alden F. Abbott and Todd J. Zywicki, *How Congress Should Protect Consumers' Finances*, in *Prosperity Unleashed: Smarter Financial Regulation* 287 (2017).

facilitate shopping, modernizing the regulatory framework, promoting conditions for innovation and competition, and facilitating access to financial services:<sup>30</sup>

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.

As described in Appendix A to the Foreword of this report, the Bureau has generated an impressive record on these objectives, but it is not clear to the Taskforce that the Bureau has dedicated the same degree of energy and attention toward facilitating inclusion, competition, and innovation, as it has to protecting consumers from improper practices. Several of the Taskforce’s recommendations focus on the ways in which Congress, the CFPB, and other regulatory agencies can act to promote those goals.

Although the concept of collecting the federal government’s consumer financial protection mission in one regulatory body is not new, the scope of authority and resources dedicated to the CFPB are. The CFPB’s rulemaking authority is far broader than held by prior federal consumer protection agencies such as the FTC. In the period since its creation, the CFPB has taken its charge to engage in substantive regulation aggressively. Some of these rulemaking and actions were mandated by Congress in the Dodd-Frank Act, such as the requirement that the CFPB issue new rules governing “Qualified Mortgages” and a consumer’s “Ability-to-Repay” mortgages as well as defining “larger participants” for several markets. Other rulemakings, by contrast, were discretionary, such as additional larger participant rules, rules that provided new substantive underwriting regulations on small-dollar loans, a ban on class action waivers in contractual arbitration agreements (later rescinded by a Congressional Review Act resolution), a rule on prepaid cards and updated regulations on debt collection practices, to name a few. Regardless of

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<sup>30</sup> 12 U.S.C. §5511(b).

whether the rulemakings were required or discretionary, however, the end result has been a significant increase in substantive regulation activity by the federal government.

The Dodd-Frank Act and the CFPB also added new regulatory tools to the federal regulatory apparatus. Enforcement of federal consumer financial protection laws had always been present, mostly through the FTC and Department of Justice. Prudential regulators examined regulated entities for compliance with consumer protection laws and could issue penalties for violations. But enforcement, supervision, and regulation were patchwork affairs and often led to inconsistency and incoherence in consumer financial protection law.<sup>31</sup> Moreover, many products, services, and providers were regulated primarily at the state level with only sporadic and *ad hoc* intervention by federal regulators. This led to incoherent and inconsistent regulation of products that undermined competition by treating differently products that consumers view as close substitutes for one another.<sup>32</sup> The Dodd-Frank Act empowered the CFPB with broad enforcement resources and broad authority to enforce not only most enumerated federal consumer financial protection laws, but also expansive authority to prohibit any practices that are unfair, deceptive, or “abusive.” Although the terms “unfair” and “deceptive” have developed longstanding and somewhat determinate meaning over decades of usage at the FTC, the term “abusive” seems to be a wholly novel term with no clear predicate meaning in prior law.<sup>33</sup>

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

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<sup>31</sup> See Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 Geo. Wash. L. Rev. 856 (2013) (explaining the need for increasing coherence of federal consumer financial protection regulatory regime and the supporting concept of uniting federal authorities in one regulatory authority).

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

<sup>33</sup> The CFPB held a symposium in 2019 to consider the definition of the term “abusive” and later issued a policy statement in fall 2019 that provides a definition of the term. To date, the policy statement has not yet been invoked in any enforcement or rulemaking action and it is unclear to what extent the CFPB will follow it.

and others. Finally, the CFPB also has other tools and powers designed to protect consumers, including an active office of consumer education, a public-facing consumer complaint database, and an office of research staffed largely by economists.

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

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

## 6.2 Consumer Financial Protection Objectives

Assessing consumer financial protection requires consideration of two objectives. First, consumer financial protection is not an end in itself, but should be recognized as one component of a larger consumer welfare analysis. Consumers benefit not only from consumer protection narrowly understood, but also from greater choice, innovation, and competition that drives higher quality and lower prices. Second, to the extent that consumer protection efforts are inefficiently designed and implemented, they can have the unintended consequences of reducing access, deterring innovation and competition, and raising prices. But even more, poorly tailored regulation can actually result in *greater* harm to consumers by creating market power for some providers or by depriving vulnerable consumers of useful products that can force them to turn to inferior products and providers. Therefore, the scope of consumer protection must be properly defined as well as the particular harms to consumers that consumer protection law seeks to

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<sup>34</sup> See 12 U.S.C. §5511(c).

remedy, such that the benefits of consumer protection interventions actually aid consumers and make them better off.

## 6.2.1 Consumer Financial Protection Goals

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

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

Consumer welfare is maximized when informed consumers can find the financial products and services they need in a competitive marketplace. Under these circumstances, voluntary transactions are beneficial to consumers, providers of financial services, and the national economy. In addition, a well-functioning consumer financial system is crucial to the overall national economy; approximately 70 percent of American economic activity is related to consumer spending, and much of that economic activity is enabled by financial access to bank accounts, credit cards, and other consumer financial products. As painfully learned during the

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<sup>35</sup> See Zywicki, *Savior or Menace?*, supra note 31.

<sup>36</sup> See Christopher Mufarrige and Todd Zywicki, *The Limits of Consumer Protection* (working paper, Sept. 2020); see also Frank Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1 (1984).

2008 financial crisis and subsequent Great Recession, a breakdown in the consumer financial system can have dramatic adverse effects on the overall economy. By equal measure, the resilience of the nation's retail economy in response to the COVID-19 pandemic was possible only because of the ability of the free market to adapt to a rapid transition to online and non-face-to-face transactions and the rapid abandonment of cash transactions. Fraudulent, deceptive, and unfair practices interfere with this benevolent process, however, by enabling fraudulent providers to lure consumers into transactions that leave them worse off and enable crooked providers to lure business away from legitimate competitors. Rules that prohibit fraud, deception, and unfair practices, therefore, improve market efficiency, consumer welfare, and the competitive process.<sup>37</sup> Moreover, absent assurances that they will not be taken advantage of by overreaching financial services providers, consumers will be reluctant to use financial products, thereby foregoing the benefits from doing so.

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

The demand side, however, will exhibit the opposite dynamics. In deciding whether to borrow, consumers will consider the total costs of the loan, including not just the nominal price of the loan (such as the interest rate) but also the expected cost of potential default. Harsher and more

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

<sup>38</sup> See NCCF Report, *supra* note 1, at Chapter 3.

<sup>39</sup> See Todd J. Zywicki, The Law and Economics of Debt Collection and Its Regulation, 28 Loyola Consumer L. J. 167 (2016).

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



immediate remedies will be more costly to some consumers than others but will be especially relevant to those who are most likely to default. Limiting remedies, therefore, will increase the quantity demanded of consumer credit, as consumers will be more willing to borrow and take on credit where the consequences of delinquency and default are less costly.<sup>41</sup>

A restriction on creditors' remedies, therefore, will have two simultaneous and offsetting impacts: it will simultaneously reduce the quantity supplied of credit and increase the quantity demanded.<sup>42</sup> Thus, the end result will unambiguously be a higher equilibrium price for credit, but the equilibrium quantity of credit could be either lower *or* higher, depending on how lenders and borrowers adjust to the new mix of prices and remedies.

The point can be illustrated in Figure 6-1.

**FIGURE 6-1:** EQUILIBRIUM PRICE-QUANTITY OF CREDIT

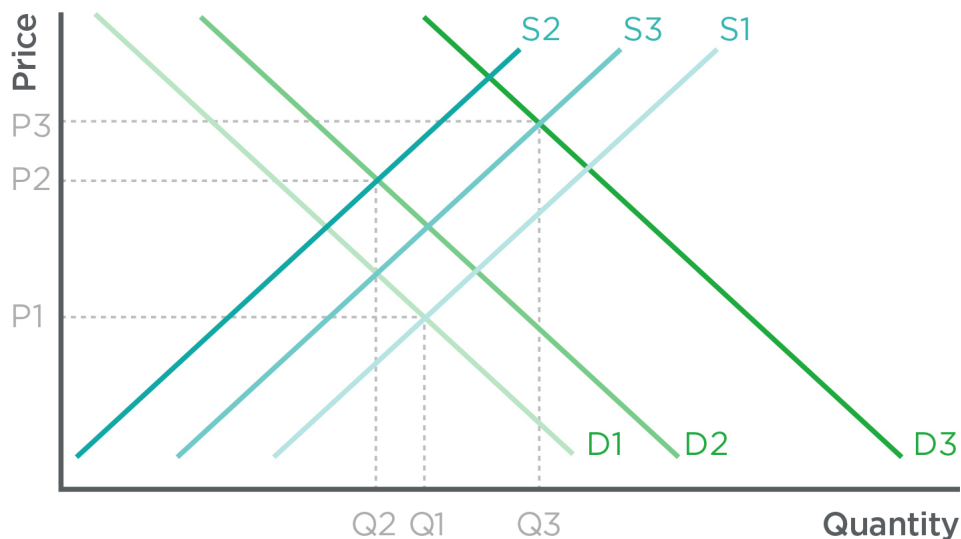


Figure 6-1 illustrates an inefficient restriction on creditors' remedies that reduces the equilibrium quantity of credit. Although consumer demand shifts out from D1 to D2, the supply shift from S1 to S2. In other words, the hypothetical restriction illustrated in Figure 6-1 is harmful to consumers in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

<sup>41</sup> Note that the economics of interest rate controls are identical—lenders will reduce the quantity supplied of loans and consumers will increase their demand for credit at the controlled price.

<sup>42</sup> Zywicki, *Debt Collection*, *supra* note 39.

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

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

Regulation will have distributional effects in addition to efficiency effects. Interest-rate ceilings on consumer financial products traditionally have been justified as beneficial for low-income consumers. As is the case with the effect of usury laws, inefficient restrictions on creditors' remedies will also end up hurting higher-risk consumers more than lower-risk consumers.<sup>44</sup> Inefficient regulations increase the costs of collections by reducing the efficacy of collection measures, thereby increasing losses and reducing the returns per dollar invested in collections. As a result, restrictions on creditors' remedies will increase the risk and cost of lending to all potential borrowers but will increase the risk of lending to higher-risk consumers most. *Ex post*, riskier consumers would benefit most from strict restrictions on collection activities as they are most likely to default and be subjected to collection efforts. But *ex ante*, these same consumers are those who are most likely to be harmed from excessively strict limits on creditors' remedies once offsetting adjustments by creditors are taken into account. Regulatory limits will lead to compensating adjustments by lenders to reduce losses, most notably leading to higher lending underwriting standards and rationing lending to riskier consumers (as well as reducing available credit lines to most consumers), but also higher interest rates, requiring larger down payments,

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

<sup>44</sup> See Zywicki, *Debt Collection*, *supra* note 39.

and shorter maturities (resulting in higher monthly payment obligations).<sup>45</sup> Lower-income consumers will have greater difficulty coming up with liquid funds for a larger down payment or meeting higher monthly payment obligations than will higher-income consumers.<sup>46</sup> In addition, there are many costs associated with collecting debts that do not scale one-to-one with the size of the loan; as a result, smaller loans are more expensive to collect per dollar loaned than larger loans.<sup>47</sup> As a result, lenders will also raise their minimum loan size to an amount that is economically feasible to collect.<sup>48</sup> Higher minimum loan size will exclude low-income and higher-risk borrowers that could have qualified for a smaller loan but are unable to be underwritten at a larger loan size. Overall, therefore, although economically inefficient restrictions on creditors' remedies benefit those borrowers who do not pay their obligations, they create costs for other higher-risk consumers who pay higher interest rates and gain less access to credit.<sup>49</sup>

Much of modern debate over the scope and substance of consumer financial regulation rests on an implicit assumption that consumer financial regulation must be zero-sum in nature, i.e., that regulation rests on a zero-sum single dimension continuum of conflict between “consumers” and “industry” and that any reduction in the cost of consumer financial regulation (i.e., “deregulation”) must be “good” for industry and “bad” for consumers, and vice-versa. The Taskforce rejects this zero-sum conception as a useful way to think about consumer protection law; indeed, it rejects the usefulness of the idea of “deregulation” generally. Instead, the Taskforce recognizes the crucial role played by well-designed consumer protection rules, regulations, and enforcement, not only in protecting consumers from fraud and other oppressive practices, but also in protecting upstanding businesses from market distortions caused by fraudulent businesses and the adverse effects on consumer confidence that those practices can cause. As a result, the Taskforce expressly rejects the construct of “deregulation” versus “more

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<sup>45</sup> See Douglas F. Greer, Creditors Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections, in 5 Technical Studies of the National Commission on Consumer Finance 154 (1973); James A. Barth, et al., The Effect of Government Regulation of Personal Loan Markets: A Tobit Estimation of a Macroeconomic Model, 38 J. Fin. 1233 (Sept. 1983); James R. Barth, Joseph J. Cordes, & Anthony M. Yezer, Benefits and Costs of Legal Restrictions on Personal Loan Markets, 29 J. L. & Econ. 357 (1986); William C. Dunkelberg, Banks Lending Response to Restricted Creditor Remedies (Credit Research Ctr. Working Paper No. 20, 1978); Viktor Fedaseyev, Debt Collection Agencies and the Supply of Consumer Credit, Fed. Res. Bank of Philadelphia Research Department Working Paper WP 20-06 (Feb. 2020).

<sup>46</sup> Higher-income consumers are also more likely to have access to assets that can provide collateral for a loan, such as home equity lines of credit. See Zywicki, *Debt Collection*, *supra* note 39; see also Richard M. Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 Am. L. & Econ. Rev. 168 (2002).

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

<sup>48</sup> See Dunkelberg, *supra* note 45, at 9.

<sup>49</sup> See Zywicki, *Debt Collection*, *supra* note 39.

regulation” as a useful way of thinking about consumer protection. Instead, the Taskforce believes that the overall objective of consumer financial protection policy should be to adopt rules, regulations, and practices that protect consumers from harm; improve consumer welfare overall; promote fair and transparent markets and eliminate practices that interfere with that goal. Rules that promote transparency and facilitate shopping, such as well-designed information disclosure rules, and rules that promote fair treatment of consumers, such as well-designed limits on creditor remedies, can provide benefits to consumers, providers, and the overall economy.

## 6.2.2 The Role of Consumer Financial Protection Regulatory Agencies

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

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

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

### Competition

The first leg of the stool is competition and the market process. It is recognized that competition brings about lower prices and greater variety for consumers. Often overlooked, however, is that

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<sup>50</sup> See Johnson, *supra* note 37; see also J. Howard Beales III & Timothy J. Muris, *FTC Consumer Protection at 100: 1970s Redux or Protecting Markets to Protect Consumers?*, 83 George Washington L. Rev. 2157 (2015). The three-legged stool analogy is adapted from Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 Tex. Rev. of L. & Pol. 393, 400 (2001).

<sup>51</sup> Johnson, *supra* note 37.

<sup>52</sup> Beales & Muris, *supra* note 50, at 2163.

<sup>53</sup> As discussed below, we include within this third leg of the stool the value of competitive federalism and experimentation among different state regulatory systems.

competition also promotes consumer protection goals. By giving consumers a variety of providers of financial products and services in the market, dissatisfied consumers can walk away from low-quality or underperforming companies. This threat of punishment for businesses that do not satisfy their customers can provide a powerful check on opportunism and low quality.<sup>54</sup> Often, the economic fallout from a scandal or reports of consumer mistreatment will far exceed the costs to the company from any direct regulatory costs or fines.<sup>55</sup> Jobs are frequently lost, including those of senior management. In addition, trusted third-party evaluators, such as Consumer Reports or JD Power, provide valuable information about various providers of services.

Advertising also provides information about new products and services as well as comparative information about rival sellers.<sup>56</sup> For example, Southwest Airlines has made its tag line “Bags Fly Free” and other elements of price transparency a defining characteristic of its customer brand, along with eschewing other similar fees, such as schedule change fees and the like. According to a subsequent analysis, although Southwest’s decision to forego such fees cost it an estimated \$500 million per year in new revenues, the company more than offset that amount by increasing its market share by two percentage points, increasing passenger loads by 10 percent, and \$2 billion in incremental annual revenue.<sup>57</sup>

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

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<sup>54</sup> See L. G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. Bus. 27 (1980); Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

<sup>55</sup> See Thomas D. Dowdell, Suresh Govindaraj, and Prem C. Jain, *The Tylenol Incident, Ensuing Regulation, and Stock Prices*, 27 J. Fin. and Quantitative Analysis 283 (1992); Mark L. Mitchell and Michael T. Maloney, *Crisis in the Cockpit? The Role of Market Forces in Promoting Air Travel Safety*, 32 J. L. & Econ. 329 (1989); Mark L. Mitchell, *The Impact of External Parties on Brand-Name Capital: The 1982 Tylenol Poisonings and Subsequent Cases*, 27 Econ. Inquiry 601 (1989).

<sup>56</sup> The role of advertising in the competitive process is discussed in greater detail in Chapter 7.

<sup>57</sup> See Geoffrey Manne & Todd J. Zywicki, *Uncertainty, Evolution, and Behavioral Economic Theory*, 10 J. L. Econ. & Pol’y 555 (2014).

<sup>58</sup> Consumer Financial Protection Bureau, Arbitration Study Section 3 page 3 (March 2015).

<sup>59</sup> Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 Fed. Res. Bulletin 1 (Issue 5, Dec. 2013); see also Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 Federal Reserve Bulletin 623 (200).

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

In turn, financial service providers seek to keep their customers happy in order to preserve the benefits of the relationship as well as the company’s positive reputation with customers. Acquisition of new customers is expensive, and banks will find it far less expensive in the long run to keep a loyal customer satisfied than to fight over a few overdraft or late fees. Thus, the first step most consumers take if they feel that they have been assessed an unfair fee is to complain to the bank and ask for a refund, with the implied threat of changing banks if they are not satisfied. This desire to retain consumers often leads the bank to voluntarily issue a refund. Examining the reports of one medium-sized regional bank, for example, Johnston and Zywicki found that overall, in about 68 percent of cases in which consumers complained about a fee (such as an overdraft fee or wire transfer fee), the bank issued a complete refund.<sup>61</sup>

The value of treating customers fairly is illustrated by the public response to the infamous Wells Fargo “fake account” scandal that came to light in 2016.<sup>62</sup> A survey of consumers soon thereafter found that “positive perceptions” of the bank fell from 60 percent before the scandal to 24 percent after the scandal, while negative perceptions increased from 15 percent before the scandal to 52 percent post-scandal. In addition, 30 percent of Wells Fargo customers stated that they were actively exploring other alternative banks, and 14 percent had already made the decision to switch banks as a result of the scandal. Overall, one analysis estimated that Wells Fargo would lose approximately \$99 billion in deposits and \$4 billion in revenue as a result of customer fallout from the scandal. Moreover, only 3 percent of potential new customers stated that they would be willing consider doing business with the bank.<sup>63</sup>

Social media has increased the potential reputational harm to financial services providers from satisfied dissatisfied consumers by amplifying their experiences. Websites such as Yelp and

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<sup>60</sup> Canner & Elliehausen, *supra* note 59.

<sup>61</sup> See Jason Scott Johnston & Todd Zywicki, *The Consumer Financial Protection Bureau’s Arbitration Study: A Summary and Critique*, 35(5) Banking & Fin. Servs. Pol’y Report 9, 20 (May 2016).

<sup>62</sup> See Matt Egan, *Wells Fargo’s Reputation is Tanking, Survey Finds*, CNN.com (Oct. 25, 2016), available in <https://money.cnn.com/2016/10/24/investing/wells-fargo-fake-accounts-angry-customers/index.html> (summarizing report by cg42 consulting).

<sup>63</sup> *Id.*.

Google enable consumers to testify directly to their experiences with various providers and products. Testimonials of actual consumer experiences ameliorate the traditional information asymmetries between consumers and providers of services, even in traditional redoubts of government regulation, such as occupational licensing. Recent research finds that consumers today place greater value on the experiences of other consumers, as measured by online reviews, than they do on traditional criteria such as government-issued licenses.<sup>64</sup>

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

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

## Common Law

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

Market forces, particularly the desire to retain repeat customers and to prevent adverse reputational consequences provide a powerful motive for keeping one’s promises and eschewing fraud. But there are limits to this incentive for self-enforcing promises. For example, a seller

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

might believe that there is a low likelihood that a consumer might detect the improper behavior and thereby punish the miscreant business. Or the seller might face attenuated competitive constraints, such as market power, that enable them to cheat consumers with minimal fear of punishment. Or the seller might simply believe that the short-term benefit of cheating a consumer or group of consumers exceeds any damage to the business's reputation at large. Regardless of the possible source of market failure, legally enforceable private rights of action for fraud, warranty, and the like, provide a vehicle for wronged consumers to vindicate their rights and gain recompense from seller misbehavior.

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

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

In theory, class action lawsuits provide a mechanism for pooling together many small claims of wrongdoing and thereby creating an incentive to sue. But class action proceedings are riven with their own problems for consumers, most notably that the small stakes involved in any given case for an individual plaintiff tempers the incentive for any one of them to monitor the actions of their lawyers closely.<sup>65</sup> This can produce class actions settlements that are far more beneficial for

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<sup>65</sup> See Jason School Johnston and Todd J. Zywicki, *The CFPB's Arbitration Study: A Summary and Critique*, 35(5) Banking and Fin. Servs. Pol'y Report 9 (2016).



class counsel than for class members, as class members might receive nominal redress while their lawyers receive substantial legal fees.

Moreover, as Jason Johnston has observed, some class action cases are brought despite an absence of tangible harm to any consumer.<sup>66</sup> These “no harm” cases produce no obvious benefit to consumers because of the absence of any harm, yet they impose a cost on the company that must eventually be passed on to other customers. Often these cases involve claims to vindicate laws that provide for a minimum size of “statutory damages” for a violation, such as \$500 or \$1000 per violation, without requiring showing of actual harm to the consumer. Ironically, statutory damages were often provided in the first place in order to provide adequate economic incentives for individual plaintiffs to sue in response to alleged violations by providing sufficient damages to make such a suit economically worthwhile. When combined with the class action process, however, the presence of statutory damages can dramatically increase the damages for a violation that far exceeds any actual harm to consumers from the violation.<sup>67</sup>

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

### 6.2.3 Regulatory Agencies

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

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<sup>66</sup> See Jason Scott Johnston, High Cost, Little Compensation, No Harm To Deter: New Evidence on Class Actions Under Federal Consumer Protection Statutes, 2017 Colum. Bus. L. Rev. 1 (2017).

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

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

Well designed and executed public agencies are essential to the institutional framework of consumer protection. They can help markets work better for consumers and address market failures when market and common law responses are insufficient to maximize consumer welfare. By preventing fraud and other harms to consumers, public agencies can help ensure that the competitive process is fair and efficient for consumers.<sup>68</sup> Much of the Taskforce's effort has been devoted to identifying ways to help public agencies work better.

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

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

First, agencies inevitably suffer from the knowledge problem associated with seeking to collect and synthesize information that is then transmitted as data into decisions by consumers and

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<sup>68</sup> See discussion in Chapter 8.

<sup>69</sup> See Maxwell Stearns, Todd J. Zywicki, and Thomas Micelli, Law and Economics: Private and Public 798-806 (discussing characteristics of agency decision-making).

businesses.<sup>70</sup> Although agencies can collect data and other types of evidence, this information is not the same as the knowledge of “time and place” that arises from particular individuals making particular decisions in particular contexts under particular constraints.<sup>71</sup> For example, most auto title pawn customers are consumers. Yet research indicates that some customers who appear to be ordinary individuals are actually small, independent businesspeople who use their vehicle (van or pickup truck, for example) as a source of short-term business finance.<sup>72</sup>

For example, a landscaper might pledge his truck on Monday to gain access to cash to buy mulch, sod, bushes, and labor, then perform yardwork the next two days and be paid at the end of the week at which he will redeem the vehicle loan. A handyman or painter might similarly pledge their vehicle to access short-term cash to purchase supplies that is repaid just a few days later on completion of the job. As a result, a particular individual might access multiple loans over a several month period, but each one is repaid quickly, with a high degree of certainty, and with minimal interest charges. To the regulator, however, this individual might appear to be a one-size-fits-all individual caught in a so-called “debt trap” who borrows repeatedly. The lender and customer, by contrast, are more likely to know the real purpose of the transactions and whether they are problematic. Selecting an arbitrary variable, such as the number of loans that a borrower is permitted to use, can also produce harmful adjustments and offsetting behavior by borrowers, such as keeping an auto title loan outstanding for a longer period of time, or borrowing a larger amount of money than needed as a hedge against future needs, that could produce more finance charges than would otherwise occur.

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

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<sup>70</sup> See Christopher Mufarrige and Todd J. Zywicki, *Simple Rules for a Complex Regulatory World: The Case of Financial Regulation*, \_\_ European J. of L. & Econ. \_\_ (Forthcoming 2021).

<sup>71</sup> See F.A. Hayek, *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519 (1945).

<sup>72</sup> See Todd J. Zywicki, Consumer Use and Government Regulation of Title Pledge Lending, 22 Loyola Consumer L. Rev. 425 (2010); Jim Hawkins, Credit on Wheels: The Law and Business of Auto-Title Lending, 69 Wash. & Lee L. Rev. 535 (2012).

<sup>73</sup> See Adam C. Smith and Todd Zywicki, Behavior, Paternalism, and Policy: Evaluating Consumer Financial Protection, 9 NYU J. L. & Liberty 201 (2015).

<sup>74</sup> See Board of Governors of the Federal Reserve System, Design and Testing of Overdraft Disclosures: Phase Two 18-19 (Oct. 12, 2009).

contexts until they are actually confronted with those choices.<sup>75</sup> Moreover, when confronted with the exact same choice in the exact same situation, different individuals might make different choices. For example, depending on their situation and personal preferences, one person might be willing to borrow money to buy a minivan when they have children, while someone else might not be willing to do so until they saved up enough to purchase it with cash. In short, the economic value that people place on various consumption goods and the use of credit to purchase them is “subjective”—not only do different people choose differently from one another, the *same* person might make different choices in different contexts or at different times.<sup>76</sup> Unless it is done carefully, government regulation intended to help can actually harm consumers if it fails to take account of these subjective preferences that people hold and the different contexts in which they make decisions.

A second danger with agency action and government regulation is the problem of incentives, both from external interest-group pressures as well as the agency’s internal dynamics.<sup>77</sup> Just as the incentives of providers of financial services and class action lawyers sometimes can be imperfectly aligned with maximizing consumer welfare, government officials can face imperfectly aligned incentives as well.

Where authority for consumer protection law and policy is guided by an elected official, such as a state attorney general (AG), optimal long-term consumer protection policy can be imperfectly aligned with short-term political incentives. In carrying out their enforcement activities, elected AGs will have at least one eye focused on the political elements and consequences of their actions, both for the electorate at large but also for important interest groups that disproportionately influence the AGs political fate either for re-election or for promotion to higher office.<sup>78</sup> Elected officials also tend to overweight the short term benefits and costs of consequences of actions relative to the long term. In addition, AGs also will have their own

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<sup>75</sup> Thomas Sowell, Knowledge and Decisions 218 (1980) (“The real problem is that the knowledge needed is a knowledge of *subjective patterns of trade-off that are nowhere articulated*, not even to the individual himself. I might *think* that, if faced with the stark prospect of bankruptcy, I would rather sell my automobile than my furniture, or sacrifice the refrigerator rather than the stove, but unless and until such a moment comes I will never *know* even my own trade-offs, much less anybody else’s.”).

<sup>76</sup> Todd J. Zywicki, A Unanimity-Reinforcing Model of Efficiency in the Common Law: An Institutional Comparison of Common Law and Legislative Solutions to Large-Number Externality Problems, 46 Case Western L. Rev. 961 (1996) (discussing subjective value); James M. Buchanan, Cost and Choice: An Inquiry in Economic Theory (1969).

<sup>77</sup> See James M. Buchanan and Gordon Tullock, The Calculus of Consent 204-212 (1999) (originally published 1962); Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (1965).

<sup>78</sup> See Colin Provost, The Politics of Consumer Protection: Explaining State Attorney General Participation in Multi-State Lawsuits, 59 Political Research Quarterly 609 (2006).

personal policy agendas they desire to promote while in office.<sup>79</sup> How these various and competing political influences of the public, interest groups, and their own personal agendas will play out in practice is difficult to predict. What is not difficult to predict, however, is that the agency's consumer protection agenda will be influenced by political considerations as well as what factors constitute optimal long term policy for consumers.<sup>80</sup>

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

But eliminating external democratic oversight does not eliminate the influence of politics and ideology. Agencies are also subject to internal political pressures arising from their staff. Precisely because of the attenuated external political control over public agencies, the staff of those agencies has a greater range of discretion to influence policy and to advance their own ideological and personal goals. In some instances, this discretion permits agency employees to aggressively expand the agency's reach to regulate behavior beyond that which is reasonably in its scope.<sup>82</sup> To some extent, this imperialistic drive arises from the natural self-interest of agency personnel to advance their own careers and to expand the power, prestige, and budget of the agency.<sup>83</sup> In addition, staff employees have their own ideological and political views that can dramatically influence the agency's direction and temper efforts to redirect the agency's mission in accordance with either the President's or Congress's vision.<sup>84</sup> Professor Roberta Romano has

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<sup>79</sup> See Colin Provost, *An Integrated Model of U.S. State Attorney General Behavior in Multi-State Litigation*, 10 *State Politics and Policy Quarterly* 1 (2010).

<sup>80</sup> See Colin Provost, *When is AG Short for Aspiring Governor? Ambition and Policy Making Dynamics in the Office of State Attorney General*, 40 *Publius: The Journal of Federalism* 597 (2010).

<sup>81</sup> See Barry R. Weingast and Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 *J. Pol. Econ.* 765 (1983).

<sup>82</sup> See Stearns, Zywicki, & Micelli, *supra* note 69, at 781-98 (2018).

<sup>83</sup> See William A. Niskanen, Jr., *Bureaucracy and Representative Government* (1971).

<sup>84</sup> See Timothy J. Muris, *Regulatory Policymaking at the Federal Trade Commission: The Extent of Congressional Control*, 94 *J. Pol. Econ.* 884 (1986); Zywicki, Saviar, *supra* note 35.

argued that the CFPB's lack of democratic oversight has also led it to favor less transparent and less publicly accountable mechanisms for policy making.<sup>85</sup> Moreover, those who head agencies might have future elective or appointive political ambitions themselves, which could influence their decision-making while running the agency.<sup>86</sup> In general, the greater the degree of independence and insulation of agencies from oversight and control by democratically-elected officials, the greater also will be the opportunities for those within the agency to shape it according to their own goals and vision rather than those of the democratically-accountable officials.<sup>87</sup>

Thus, just as “market failure” predictably can occur, so can “political failure.”<sup>88</sup> As a result, just as markets and common law are imperfect institutions, legislative and regulatory bodies are imperfect as well. In determining the optimal allocation of authority among various institutions it is important to avoid the “Nirvana Fallacy,” i.e., the assumption that just because one institution is imperfect that some other institution must function better.<sup>89</sup> How regulatory agencies can assess the wisdom and efficacy of interventions is discussed below.

## Special Cases of Market Failure

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

Examples of service providers that provide consumer services but which the consumer lacks the authority to control, hire, and fire, include those such as debt collectors, credit reporting

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<sup>85</sup> See Roberta Romano, Does Agency Structure Affect Agency Decisionmaking: Implications of the CFPB's Design for Administrative Guidance, 36 Yale J. on Reg. 273 (2019).

<sup>86</sup> Zywicki, *Savior*, *supra* note 35.

<sup>87</sup> This is a phenomenon known as “agency drift” as the agency's actions “drift” from the policy preferences of the enacting Congress. See David Epstein and Sharyn O'Halloran, *Administrative Procedures, Information, and Agency Discretion*, 38 Am. J. Pol. Sci. 697 (1994).

<sup>88</sup> James M. Buchanan, *Market Failure and Political Failure*, 8(1) Cato J. 1 (1988).

<sup>89</sup> Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J. L. & Econ. 1, 1 (1969) (“In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient.”).

agencies, and mortgage servicers. Not coincidentally, the consumer reporting industry and debt collection industry are the top two sources of consumer complaints in the CFPB's Consumer Complaint Database, and mortgage complaints rank fourth.<sup>90</sup>

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

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

But while this symmetrical conclusion intuitively suggests the presence of a market failure, it is incomplete. Although third-party debt collectors potentially might be over-aggressive in their collection efforts in some cases, a creditor that collects its own debt might be insufficiently aggressive from an economic perspective. In particular, where the debtor stands in a repeat-dealing relationship with the creditor, it is not necessarily the case that collection efforts might be too aggressive. In fact, they might actually be somewhat less aggressive than optimal. That would be the case, for example, if the lender is a retailer extending credit to an existing customer. The retailer would obviously be concerned about collecting past due debt. But the retailer would balance this concern of minimizing losses on past due accounts, which would support aggressive collection measures, against a countervailing pressure to retain the customer for future shopping purchases. In the latter instance, the retailer might be more passive in collecting past due debt than otherwise would be economically efficient, with some of those losses being passed on to

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<sup>90</sup> All together those three industries comprised 73 percent of all the complaints in the CFPB's database in 2019. *See* Consumer Financial Protection Bureau, Consumer Response Annual Report, January 1-December 31, 2019, at 9, Fig. 2 (March 2020).

other consumers.<sup>91</sup> And, consistent with that idea, data collected by the NCCF suggested that retailers carried unpaid customer balances longer than other creditors such as banks and finance companies.<sup>92</sup> This does not necessarily demonstrate that other creditors were pursuing efficient debt-collection strategies and retailers were not, but it demonstrates the importance of repeat-dealing in shaping behavior regarding debt collection.

Third-party credit cards, such as bank-issued cards under the Visa or MasterCard logo or American Express or Discover, address part of this problem by enabling retailers to outsource the task of becoming creditors in the first place. Retailers can thereby concentrate on selling goods to consumers, which is their area of expertise, and can outsource the cost and risk of running credit operations and the unpleasantness of trying to collect delinquent debt from an otherwise good customer. Third-party debt collectors help to address this incentive problem with respect to optimal levels of collection efforts as well. By outsourcing debt collection to third parties, the original issuers of the debt can effectively collect the debt while insulating themselves from some of the repeat-dealing and reputational consequences associated with carrying out the combative process of debt collection.<sup>93</sup> Third-party collectors can thus be expected to be more aggressive than originating creditors in collecting debts, which will which will reduce losses and increase recoveries.

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

Moreover, default and many collections terms are set in the original contract between the consumer and originating creditor and are binding on the collections firm. As noted, this means that creditors will tend to restrain their demands for certain remedies and collection methods in

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<sup>91</sup> See Zywicki, *Debt Collection*, *supra* note 39.

<sup>92</sup> *Id.*

<sup>93</sup> Zywicki, *Debt Collection*, *supra* note 39.



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

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

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

Credit reporting agencies raise similar issues from a consumer protection perspective. Credit reporting agencies receive information directly from creditors without the consumer's

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<sup>94</sup> Zywicki *Debt Collection*, *supra* note 39, and sources therein

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

permission. As with debt collection, if a consumer were authorized to control their information, each individual consumer would permit only positive, not derogatory information, to credit bureaus. But the selective reporting of only positive information would dramatically reduce the information content of credit bureaus. On the other hand, credit bureaus do not have an incentive to collect only negative information, because reporting both positive and negative information on consumers provides more accurate information than reporting only negative information, simultaneously producing lower delinquency rates and an expansion in the number of loans made for a given pool of consumer applicants.<sup>96</sup> Thus, they have some incentive to provide a full and accurate picture to their customers.

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

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

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

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<sup>96</sup> See John M. Barron and Michael E. Staten, *The Value of Comprehensive Credit Reports: Lessons from the US Experience*, in *Credit Reporting Systems and the International Economy* (Margaret Miller ed., 2003).

## 6.3 Regulation by Public Agencies

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

### 6.3.1 What Is a Consumer Protection Issue?

As a threshold question it is necessary to first understand: what is a consumer protection issue? Consumer protection issues arise from contexts in which consumers make decisions that reduce their individual welfare and are not reasonably able to avoid that result, such as decisions made in the absence of competitive alternatives or as the result of deceptive or unfair practices.

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

Consider the example of “rational default” on consumer loans. Multiple factors influence whether consumers will default on an extension of credit including large unexpected expenses or macroeconomic conditions that lead to default for reasons largely beyond consumers’ control, such as job loss. But in some instances, consumers default not because they are unable to repay the obligation but because they choose not to repay. In this latter situation, consumers’ decisions to default may be “rational” in the sense that on net, the benefits of not paying the obligation exceed the costs of choosing not to pay, and default results from a rational response to incentives to default instead of paying the debt. Economists model the decision whether to default on a loan as an “option” contract, and predict that if the benefits of default increase or the costs of default decrease, consumers will be more likely to elect to default.

The concept of rational default is straightforward. Consider the decision whether to default on a standard 30-year mortgage.<sup>97</sup> Each month consumers have a choice—to make the monthly mortgage payment or choose not to make the monthly installment payment. The decision to make a payment in any given month is analogous to a “call” option in finance. By making the monthly payment installment, the borrower retains the option to eventually purchase the underlying asset (the home). If a consumer exercises this option for 360 consecutive months, at the end of that period she will own title to the asset free and clear. The decision to default, on the other hand, is analogous to a “put” option. The consumer can choose *not* to make the monthly payment and instead exercise the option to not buy the home and, eventually, to permit the lender to foreclose on the home and take possession and resell the collateral. Of course, consumers will decide whether to pay or default based on their subjective assessment of the benefits and costs of the alternative options. Nevertheless, the same basic model of rational default applies to any consumer loan, including credit cards, payday loans, or a payday loan. In this sense, economists model the default decision by consumers as not fundamentally different from that of a business or commercial enterprise.

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

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<sup>97</sup> See Todd J. Zywicki and Gabriel Okloski, *The Housing Market Crash*, Mercatus Center Working Paper No. 09-35 (Sept. 2009), available in <https://www.mercatus.org/publications/financial-markets/housing-market-crash>.

<sup>98</sup> *Id.*

<sup>99</sup> Kerry D. Vandell, How Ruthless Is Mortgage Default? A Review and Synthesis of the Evidence, 6 J. Housing Res. 245 (1995); James B. Kau & Donald C. Keenan, An Overview of the Option-Theoretic Pricing of Mortgages, 6 J. Housing Res. 217 (1995); Patric H. Hendershott & Robert Van Order, Pricing Mortgages: An Interpretation of the Models and Results, 1 J. Fin. Services Res. 19 (1987).

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

Consumers are also more likely to exercise their option to default when the benefits of defaulting increase.<sup>103</sup> For example, in most states if a borrower defaults on her mortgage, the lender can not only repossess the collateral and sell and apply the value to the outstanding debt, the lender can also sue the borrower personally for any remaining deficiency. In some states, however, the lender is limited only to foreclosing on the home and cannot reach the borrower's personal assets. In such situations, the cost of default is much lower because the borrower can protect her personal assets. Empirical research has found that the presence of anti-deficiency laws (also referred to as non-recourse laws) can substantially increase the frequency of default and foreclosure, especially when housing prices fall (thereby providing the borrower with an incentive to walk away).<sup>104</sup> Most striking is that this incentive effect to default is greatest with respect to higher-value houses, which suggests that wealthier homeowners are most likely to benefit from

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

<sup>101</sup> “Strategic default” refers to the practice of intentionally defaulting on some obligations while continuing to pay others. During the financial crisis of 2008, for example, many consumers chose to default on their mortgages while continuing to pay their other loans, such as credit cards, student loans, and car loans. In most instances this was because their mortgage was in a negative equity position and so it was rational for them to stop paying on that asset. See Luigi Guiso, Paola Spienza, and Luigi Zingales, *The Determinants of Attitudes toward Strategic Default on Mortgages*, 68 J. of Finance 1473 (2013). It is also bears note that the propensity of consumers to strategically default was positively correlated with credit score, which suggests that sophisticated consumers were those who were most likely to see and act on the incentive to default. See Experian-Oliver Wyman Market Intelligence Report: Understanding Strategic Default In Mortgages, Part 1 (2009).

<sup>102</sup> Zywicki and Okloski, *supra* note 97; see also Yuliya Demyanyk and Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 Rev. of Fin. Stud. 1848 (2011).

<sup>103</sup> See Zywicki and Okloski, *supra* note 97.

<sup>104</sup> See Lawrence D. Jones, *Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans*, 36 J. L. & Econ. 115, 135 (1993).

anti-deficiency laws because those with more wealth to protect are more likely to respond to the incentives created by anti-deficiency laws .<sup>105</sup>

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

But as the model of rational default indicates, decisions about whether to default, roll over, or pay off a loan depend on the relative benefits and costs of choosing each option.<sup>108</sup> Regarding default, the 2017 Small-Dollar Loan Rule recognizes that payday lenders rarely sue delinquent customers and do not report them to credit bureaus, so those sanctions are unlikely to be significant costs default. Perhaps borrowers fear debt collection efforts, but what matters to consumers is the predicted costs of collection efforts, rather than the collection efforts that actually occur.<sup>109</sup>

Default rates on payday loans are high, which suggests that many payday loan borrowers perceive relatively low costs of defaulting. According to CFPB research, 27 percent of defaults occur without ever making a payment, and almost half of all defaults occur on the first or second

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<sup>105</sup> See Andra C. Ghent and Marianna Kudlyak, *Recourse and Residential Mortgage Default: Evidence from US States*, 24 Rev. Fin. Studs. 3139 (2011).

<sup>106</sup> See Bureau of Consumer Financial Protection, Payday, Vehicle Title, and Certain High-Cost Installment Loans, 12 CFR 1041 (Oct. 5, 2017) (hereinafter “2017 Small-Dollar Rulemaking”); *rescinded and replaced by* Consumer Financial Protection Bureau, Payday, Vehicle Title, and Certain High-Cost Installment Loans (Jul. 7, 2020).

<sup>107</sup> Id.

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

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

loan.<sup>110</sup> This group of consumers apparently believes that the cost of default is smaller than the cost of not defaulting and do not even make a single payment before choosing to default. Indeed, the quick default suggests that many borrowers intended to default at the time they first obtained the loan and had no intention to repay.

What are the benefits of rolling over a loan rather than defaulting? One hypothesis is that these consumers turn to payday loans because they have limited alternative credit options available to them.<sup>111</sup> Payday loans offer a last lifeline of access to credit for many pinched consumers. In the event of default, those borrowers will lose access to future payday loans from that same lender or perhaps other payday lenders. Thus, even if the direct adverse consequences from default are low, exercising the option to roll over the loan to preserve future access to payday loans might appear to be the best choice. If this is a primary reason why consumers rollover short-term loans, is not clear why the decision to exercise one's option to rollover the loan in order to maintain access to future credit is best explained as a conceptual model as a "trap." On the other hand, if the adverse consequences of default are high and unexpected for consumers, then that would provide support for framing these consumer decisions as raising consumer protection problems.

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

The Taskforce has been able to locate no evidence to estimate the benefits and costs to consumers of performing on their payday loan contracts instead of defaulting. It is possible that a threat of lawsuits, adverse credit reporting, or aggressive debt collection practices induce some consumers to roll over their loans. There are clear benefits to consumers from being afforded the option to extend the deadline for repayment of short-term loans, even where there is some cost associated with exercising that option. Thus, a consumer's decision whether to roll over a payday loan might reflect a rational calculation that the marginal benefits of retaining the option of keeping the loan balance outstanding for another term exceed the marginal costs of doing so, even if the cost of

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<sup>110</sup> Consumer Financial Protection Bureau, CFPB Data Point: Payday Lending 27 (March 2014). Almost half of defaults occur on the first or second loan. *See id.* at 28; *see also* Susanna Montezemolo and Sarah Wolff, Center for Responsible Lending, Payday Mayday: Visible and Invisible Payday Lending Defaults (March 2015).

<sup>111</sup> *See* discussion in Chapter 5 of the characteristics of payday loan borrowers, including their limited access to alternative credit products.

default is relatively small.<sup>112</sup> The Taskforce recommends that the CFPB conduct research to better understand why consumers choose to roll over payday loans. Similar research should be conducted for other products under the CFPB's jurisdiction where relevant, to determine whether consumer choices reflect rational responses to existing incentives or some consumer protection problem.

Correctly identifying the source of observed behaviors is crucial not only for properly identifying the presence and nature of the consumer protection problem but also to avoid unintended consequences that could harm consumers a regulation is intended to help. Most important, if a particular behavior results from consumers' responses to incentives and not fraud or some other feature that interferes with understanding, then treating the behavior as resulting from a consumer protection issue could actually exacerbate the problem. For example, although many consumers were victims of fraudulent lending practices that eventually resulted in foreclosure, many other borrowers chose to default strategically, when their homes fell in value and became worth less than was owed on the mortgage. Thus, the presence of anti-deficiency laws for residential mortgages in some states, which reduced the costs of default and increased the benefits, contributed to the severity of the 2008 foreclosure crisis by providing incentives for homeowners to default on their mortgages when home prices fell, especially among those who buy homes for investment purposes or second homes. Yet the Dodd-Frank Act provides specific statutory protections to ensure that more homeowners preserve their anti-deficiency rights under state law where relevant.<sup>113</sup> As a result, this provision will likely have the effect of *increasing* foreclosures during a future financial crisis that resembles the last one where property values fall. Thus, the failure to appreciate the logic of how consumers respond to incentives could ironically exacerbate the problem that the legislation was intended to address.

### 6.3.2 Market Failure and Government Intervention

Not every unfortunate decision by a consumer necessarily results from a market failure, and not every market failure that could reduce consumer welfare raises a consumer protection problem. Before intervening in a market, the government should take care to determine the extent of any consumer harm, the causes of that harm, and that any proposed intervention will actually improve outcomes for consumers. Although regulation and enforcement by public agencies can be uniquely valuable in protecting consumers when other institutions cannot, public action also raises unique concerns. In particular, private market activity and common law can be relatively

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

<sup>113</sup> See Dodd-Frank §1414 ("Protection Against Loss of Anti-Deficiency Provision").



nuanced and tailored to the preferences of buyers and sellers of financial products or any consumer product. Regulation often displaces voluntary transactions between consumers and providers that are generally presumed to be mutually beneficial. Moreover, the vast reach of regulatory authority and its ability to cover broadly across the market raises concerns about influence by outside special interests and the internal biases of regulatory agencies themselves can lead to regulation that fails to advance overall consumer welfare.

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

1. Is there a market failure?
2. Is there a feasible solution to address the market failure?
3. Will the benefits of the proposed intervention exceed the costs, including all unintended consequences associated with the intervention?

As this analysis makes clear, not all market failures can and should be the subject of regulatory intervention. Regulators should intervene only where market failures can be corrected with benefits exceeding the costs of doing so.

## Determine the Presence and Nature of the Market Failure

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

Usury laws provide an example of substantive regulation. Consumer financial protection in the United States was traditionally provided at the state level, which was ordered around the idea of

substantive regulation by the government of the terms and prices of consumer credit products. Usury ceilings, at root, rested on the idea that a consumer should not be permitted to pay above a certain price for any consumer loan, even if fully informed about its price and even if the consumer thought it was in their personal welfare to use the product.<sup>114</sup> As a result, the allowable interest rate on consumer loans was capped by law, even if the equilibrium market-clearing price was not, so that consumers ended up paying essentially the same overall effective price.

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

These developments in economic understanding were matched by societal changes during that era that eliminated many of the paternalistic attitudes and stereotypes that animated many of these traditional regulations. Most notable, women as a group historically were seen as less-capable of managing finances than men, a stereotype that rested on the longstanding assumption that women had poor math skills compared to men and that therefore aggressive retailers would goad them into unnecessary purchases and heavy debt.<sup>115</sup> Paternalistic restrictions on low-income consumers' ability to access credit rested on similar unfounded negative stereotypes about their alleged lack of mental acuity and impulse control, often mixed with a large dose of negative implied racial stereotyping as well.<sup>116</sup>

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

<sup>115</sup> Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* 166 (2001) (noting that installment sellers in earlier generations were criticized by consumer advocates for taking advantage of supposedly vulnerable groups such as “math-impaired females”).

<sup>116</sup> See David Caplovitz, *Consumer Credit in the Affluent Society*, 33 L. and Contemporary Problems 641, 647 (1968) (asserting without evidence that low-income consumers were lured into taking on excessive debt to engage in

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

## Identify a Proposed Remedy That Responds to a Market Failure

Second, there must be a realistic potential government remedy that addresses the identified market failure. Market failures arising from incomplete or asymmetric information that are not addressed through market solutions, such as advertising, money-back guarantees, or credible third-party verification firms, would be suitable for information remedies, such as required standardized disclosures. Market failures that are believed to flow from non-informational factors, such as alleged cognitive or self-control limits, “externalities,” or market power, are potential subjects for substantive regulation to restructure incentives, or outlaw or limit particular products or practices. Additional information is unlikely to prove effective at changing the consumer's choice under those circumstances, as the harm in question arises from forces such as misaligned incentives (in the case of externalities, for example), market power (where the consumer might be fully aware that the price exceeds the competitive price but is unable to effectively do anything about it), or cognitive limitations (that interfere with the ability of consumers to fully comprehend and appreciate the information that they are provided).

Moreover, requiring additional information to be provided might actually be counterproductive from the perspective of the consumer by increasing their confusion and making more difficult to find what information they actually care about. For example, as discussed in Chapter 7 of this Report, providing information that consumers do not actually value as part of their shopping behavior, but which regulators think consumers *should* value, can distract their attention from

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consumption, a “deviant system” that “rests in part upon the ignorance of low-income consumers and their vulnerability to fast-talking salesmen,” to which middle class families are immune). *But see* Theodore W. Schultz, *Nobel Lecture: The Economics of Being Poor*, 88 J. Pol. Econ. 639, 649 (1980) (concluding “poor people are no less concerned about improving their lot and that of their children than those of us who have incomparably greater advantages. Nor are they any less competent in obtaining the maximum benefit from their limited resources”); *see also* Jan M. Newton, *Economic Rationality of the Poor*, 36 Human Organization 50, 58 (1977) (concluding that “low income consumers are rational satisfaction maximizers and that they share the basic values and goals of other, more affluent Americans”).

important terms that they actually do care about and consider relevant, which can be characterized as “normative disclosure.”<sup>117</sup> In turn, by distracting consumers to focus on the information that regulators believe most important, at the expense of information that consumers consider most important, can lead consumers to make inferior choices than they would have without the additional information.

These two alternative approaches to regulation have been labeled “market-reinforcing” and “market-replacing” regulation.<sup>118</sup> Market-reinforcing regulation refers to regulatory action designed to “promote competition and consumer choice so that consumers can find those products that they think are best for themselves and their families.”<sup>119</sup> Market-reinforcing regulation is consistent with the disclosure-based regulatory strategy of the past several decades that is designed to help markets function and to satisfy consumer demand more effectively by enabling consumers to shop more easily among competing product providers. It also includes vigorous prosecution of fraud, deception, and other unlawful practices that undermine consumer choice.<sup>120</sup>

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

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<sup>117</sup> See discussion in Chapter 7; see also See Todd J. Zywicki, *The Market for Information and Credit Card Regulation*, 28 Banking and Fin. Servs. Report 13 (2009).

<sup>118</sup> See Todd J. Zywicki, *Market-Reinforcing versus Market-Replacing Consumer Finance Regulation*, in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers* 319 (Hester Peirce and Benjamin Klutsey, eds., 2016); see also Brian Johnson, *Deputy Director Johnson’s Speech at CFPB Symposium on Behavioral Economics* (Sept. 19, 2019), available in <https://www.consumerfinance.gov/about-us/newsroom/deputy-director-johnsons-speech-cfpb-symposium-behavioral-economics/> (describing these two approaches to regulation).

<sup>119</sup> Zywicki, *Market-Reinforcing*, *supra* note 118, at 321.

<sup>120</sup> Johnson, Deputy Director Johnson’s Speech, *supra* note, 118.

<sup>121</sup> Zywicki, *Market-Reinforcing*, *supra* note 118, at 320-21.

<sup>122</sup> Zywicki, *Market-Reinforcing*, *supra* note 118, at 321. Market-replacing regulation has also been called “command-and-control” regulation as it reflects a decision by the regulator to dictate the design of product features. See Johnson, *supra* note 37.

## The Benefits of the Proposed Intervention Should Exceed the Costs

After first determining whether a market failure exists and considering any feasible regulatory responses to that market failure, the final step before taking regulatory intervention should be to determine whether the benefits of any proposed intervention exceed the costs of the intervention, including the costs of any foreseeable and predictable unintended consequences that result from the intervention. The Dodd-Frank Act itself requires the CFPB to undertake cost-benefit analysis in determining whether to issue a rule, noting that in issuing a rule the Bureau “shall consider—the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule.”<sup>123</sup> Potential costs of intervention should include not only direct costs, such as increases in costs from regulatory compliance that will be passed through to consumers as higher prices and reduced access. But there are additional indirect costs to consumers that result from decreased choice, innovation, competition, access and inclusion. This Report returns to this theme in Chapter 13 in discussing how to apply cost-benefit analysis to proposed regulatory interventions. A few words are in order here, however.

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

As discussed in Chapter 8, one recurring cost of the structure of regulatory intervention historically has been the adverse effect on competition from creating barriers to entry, regulatory-imposed segmentation of markets among product providers, and other rules that create market power for dominant firms locally or provide competitive advantages for certain providers of consumer financial products relative to others. For example, one important effect of historic state usury regulations has been to limit the effective range of choice for consumers by promoting competition on the margin of the comparative ability of different types of product

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<sup>123</sup> 12 U.S.C. §5512(b)(2).

providers to circumvent the distorting effects of price controls on interest rates, instead of competing directly on price and quality. For example, as discussed in Chapter 10, the dominant position held by retailers in credit provision for many decades reflected the preferential regulatory status they held compared to banks and other financial service providers under the “time-price doctrine” and the ability to offset below-market pricing for credit by raising the price of appliances and other goods typically purchased on credit. This circumvention activity reduced price transparency in markets for both goods and credit as well as limiting consumer choice in credit providers to department stores and other large merchants. With respect to credit card issuers, usury ceilings led to the imposition of annual fees, which were not only economically regressive in their impact but also acted as an effective tax on card-holding by consumers, thereby dampening competition and increasing switching costs by consumers. Where regulation has the effect of dampening competition and creating regulatory-induced increased market power it is predictable that any price increase or decline in supply will be larger than would otherwise be the case.<sup>124</sup>

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

A final factor for regulators to consider is in choosing between market-replacing (i.e., substantive regulation of terms and products) and market-reinforcing rules (such as disclosure rules).<sup>125</sup> Market-replacing rules, in general, can be expected to impose higher costs on providers and consumers than market reinforcing rules. This is because, by definition, market-replacing rules foreclose consumers and providers from entering into voluntary transactions that they desire to enter into. Moreover, regulators face much higher information costs before enacting market-replacing rules because of the likelihood that their unintended costs will be higher than for market-reinforcing rules. Market-reinforcing rules, by contrast, seek to facilitate consumer choice and to enable consumers to find the products and services that they desire, rather than supplanting consumer choice with the preferences of regulators. Thus, even if the new rule

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<sup>124</sup> See Zywicki and Zuluaga, *supra* note 108.

<sup>125</sup> See Zywicki, *supra* note 118.

increases the costs to certain consumers of contracting for the products and services they desire, they are not foreclosed from doing so by regulatory mandates. Thus, although market-replacing rules might nevertheless have benefits that exceed their costs, the higher costs associated with those rules suggests that before enacting such rules, regulators should ensure that the proposed rule has substantial benefits that cannot be accomplished or approximated with a more modest rule (such as a disclosure requirement) or no rule at all. On the other hand, where consumer harm cannot be mitigated at reasonable cost through market-reinforcing rules, market-replacing rules might be appropriate. For example, many scholars have criticized the proliferation of disclosures in consumer financial regulation to the degree where they can overwhelm consumers and can be counterproductive to consumer understanding.<sup>126</sup>

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

## 6.4 Regulatory Tools

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

The CFPB is unusual in the large variety of tools that it has at its disposal. As outlined in Dodd-Frank §1021(c), CFPB has five distinct sets of “functions” or regulatory “tools”: (1) Regulation, (2) Enforcement, (3) Supervision, (4) Consumer Education, and (5) Policy Research and Development.<sup>127</sup> In addition, the CFPB also uses various informal tools, such as supervision and enforcement guidance, policy statements, and No-Action Letters, which are not so much independent regulatory tools but which help to implement those other tools. As far as the Taskforce is aware, few regulatory consumer protection regulatory agencies in the world possess such a wide variety of tools at their disposal in one agency. The FTC, for example, lacks the supervision authority that the CFPB possesses and must follow complex procedures to exercise

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<sup>126</sup> See discussion in chapter 7.

<sup>127</sup> 12 U.S.C. §5511(c).

its general rule-making authority. Most state attorneys general offices, which are the primary state authorities with respect to implementing state consumer protection laws, possess primarily enforcement powers, with limited research capacity (especially economic research) and consumer education, and virtually no regulatory or supervisory authority, which are left to state regulatory agencies or others.

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

Reviewing the CFPB's history, it is unclear what its vision and strategy have been and how to determine which tools are best suited to address particular types of problems. This lack of strategic planning has in some instances resulted in a lack of coherence and consistency across the agency in implementing some of its rules and regulations. Testimony at the CFPB's Symposium on "Abusive Acts or Practices" contended that the CFPB has applied inconsistent definitions of the term "abusive acts or practices" from different divisions of the agency, such as enforcement, rulemaking, and supervision.<sup>128</sup> For example, the interpretation of "abusive acts or practices" applied in the 2017 Small-Dollar Loan Rulemaking shows little similarity to the CFPB's use of the term in its enforcement actions.<sup>129</sup> Although supervisory oversight is necessarily confidential, the CFPB had provided very little information about how "abusive" would be interpreted and applied in that context, largely simply restating the language of the Dodd-Frank Act with minimal additional elaboration.<sup>130</sup> As a result, although each of these three tools can lay claim to being tailored to implement the "abusiveness" standard in a particular context, the fact that the CFPB possess all three of these powerful tools raises the risk of inconsistent or multiple mandates that produce costs that outweigh the benefits of regulation. The Taskforce commends

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<sup>128</sup> Statement of Todd Zywicki, Prepared for Consumer Financial Protection Bureau Abusive Acts or Practices Symposium (June 25, 2019), available in [https://files.consumerfinance.gov/f/documents/cfpb\\_zywicki-written-statement\\_symposium-abusive.pdf](https://files.consumerfinance.gov/f/documents/cfpb_zywicki-written-statement_symposium-abusive.pdf).

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

<sup>130</sup> Id.



the CFPB for adopting its policy statement to clarify its approach to abusive acts and practices. Nevertheless, it remains unclear to what extent the CFPB will follow the policy statement in practice.

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

## 6.4.1 Regulation

Regulation is arguably the most extensive and far-reaching power possessed by the CFPB.<sup>131</sup> The Dodd-Frank Act specifically mandated that the CFPB issue rules on particular subjects. The CFPB is also prohibited from issuing any rule establishing a “usury limit” for the extension of credit.<sup>132</sup> Beyond those limits, the CFPB has discretionary rule-making authority with respect to rules to implement any of its enumerated statutory authorities as well as to regulate unfair, deceptive, and abusive acts and practices. Several of the rules issued by the CFPB were required by the Dodd-Frank Act, and others were discretionary.

Regulation generally can be characterized as coming in two different forms, principles-based regulation versus rules-based regulation. Principles-based regulation rests on a set of principles of conduct and outcomes, but which then largely leaves the regulated parties and their enforcement agencies to decide how to most appropriately implement them. As summarized by Chairman of the Commodities Futures Trading Commission Heath Tarbert, “In general terms, principles-based regulation reflects a transition away from detailed, prescriptive rules toward high-level, broadly-stated principles that create standards by which regulated firms must operate. Under this approach, firms are responsible for finding the most efficient way of achieving regulatory objectives.”<sup>133</sup> Tarbert notes that principles-based regulation aims at the same objectives as rules-based regulation, “It simply does so in a way that is often more efficient and less burdensome than rules-based regulation, leaving space for flexibility and innovation.”<sup>134</sup> CFPB’s authority to prohibit “unfair, deceptive, and abusive” acts and practices is an example of principles-based regulation, in that it provides a framework of proscribed behaviors that are defined with respect to the harm that those practices cause to consumers.

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<sup>131</sup> See 12 U.S.C. §5511(c)(5) (authorizing CFPB to issue “rules, orders, and guidance implementing Federal consumer financial law”); §12 U.S.C. §5512(b).

<sup>132</sup> See 12 U.S.C. §5517(o).

<sup>133</sup> Heath P. Tarbert, Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation, 10 Harv. Bus. L. Rev. 1, 5 (2020).

<sup>134</sup> *Id.* at 6.

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

Rules-based regulation, by contrast, is highly prescriptive and typically provides not only detailed requirements but details the means to accomplish them as well, even if alternative less-expensive and more-effective means might be available. The long, detailed prescriptive menu of mandatory disclosures, both in content and format, required by the TILA, Real Estate Settlement Procedures Act, and other similar requirements exemplify the dominance of rules-based approaches over the last several decades. As the example of prohibiting "unfair" acts and practices on one hand compared to prescriptive mandatory disclosure on the other, the CFPB's status as a financial consumer protection regulator sits at a conceptual crossroads between the FTC's principles-based tradition of consumer protection and the banking regulators' rules-based approach to financial regulation.

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

A principles-based approach to regulation offers the potential for substantial benefits compared to traditional rules-based financial regulation. First, principles-based regulation has a greater degree of flexibility and adaptiveness to technological and social change that is more difficult with rules-based regulation. Rules-based regulation, by contrast, runs the risk of quickly becoming obsolete in response to changes in technology, the economy, or consumer preferences. Updating and amending rules-based regulation is an expensive and time-consuming process. Principles-based regulation also can reduce regulatory cost by offering multiple pathways to the accomplishment of the same regulatory end and otherwise permitting regulated parties to

search for the most-efficient and effective way of attaining the desired end.<sup>135</sup> Rules-based regulation also requires much higher levels of regulator knowledge to be effective, both as to the technological and economic factors that impact the rule but also regarding the most effective fit between the end goal and the means chosen to accomplish it.

On the other hand, principles-based regulation can create anxiety and uncertainty for the regulated community, especially for financial institutions long accustomed to more prescriptive regulation. This anxiety might especially be the case where the principles-based regulations are backed by the threat of enforcement with substantial potential penalties attached. Principles-based regulation can also create uncertainty when regulated entities are subject to civil liability, because multiple enforcers may apply the principles differently. Poorly designed and implemented principles-based regulation can create a chilling effect as regulated parties avoid the general zone of uncertainty that is created by the principles-based regulation. In doing so, the provider may eschew consumer-benefiting activities. Regulatory uncertainty could be especially counterproductive if those most impacted by the deterrent effect are higher-risk consumers who often benefit most from new innovations.<sup>136</sup> Principles-based regulation can also be problematic in the hands of an agency, such as the CFPB, which possesses a wide range of regulatory tools (regulation, enforcement, and supervision) and which is organized internally around those tools. The lack of precision provided by principles-based regulation (as opposed to rules-based regulation) can result in conflicting regulatory interpretations emanating from different offices of the agency. The example discussed above regarding the CFPB's seemingly inconsistent definitions of the term "abusive" when used in the context of regulation versus the context of enforcement illustrates the challenge of making principles-based regulation coherent across the agency. Lack of predictability with respect to principles-based regulation can be especially challenging in the context of CFPB rulemaking, as the Dodd-Frank Act authorizes state attorneys general under certain circumstances to enforce CFPB regulations and to pursue the expansive remedies provided by the Dodd-Frank Act. Thus, the principles may be applied in multiple fora, leading to the potential for inconsistent application. This inability to exercise tight control over the enforcement of CFPB rules could deter rulemaking where it might otherwise be optimal and lead the CFPB to use more informal guidance and the like.

The CFPB has in some instances engaged in rulemakings that contain unusually detailed and specific rules-based mandates and restrictions. For example, in its 2017 Small-Dollar Loan

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<sup>135</sup> The debate between the use of "performance standards" or "design standards" in regulatory theory is a subset of the debate over principles-based versus rule-based regulation. See Laura Montgomery, Patrick A. McLaughlin, Tyler Richards, & Mark Febrizio, *Performance Standards vs. Design Standards: Facilitating a Shift toward Best Practices*, Mercatus Center Working Paper (2019).

<sup>136</sup> See discussion at *supra* note 36 and accompanying text (discussing tradeoff between Type-I and Type –II errors).

Rulemaking, the CFPB not only required that payday lenders and auto title lenders determine that certain borrowers in certain circumstances have the “ability to repay” their loans before issuing them credit, the CFPB actually went further and dictated to the industry specific underwriting and ability to repay models that they essentially were required to use to make that determination.<sup>137</sup> Principles-based regulation, by contrast, could have permitted the regulated parties greater flexibility to apply their own underwriting model to reach the desired goal.<sup>138</sup> This decision to mandate not just an outcome but a particular underwriting model illustrates the high information costs needed for rules-based regulation to be effective.

Although rules-based regulation has its virtues and has long-dominated the financial regulation sector, the accelerating speed at which technology, society, and the economy are changing is increasingly incompatible with the detailed and inflexible nature of rules-based regulations. Moreover, as the mandates and requirements of the regulatory state have become increasingly dense and complex, even the primary purported virtue of rules-based regulation—their apparent clarity and predictability—has become less valuable because of possible competing mandates and high compliance costs. Moreover, even if rules-based regulation increases predictability in the short-run, the constant need for updating those rules in response to external technological, market, and social changes increases unpredictability across time.<sup>139</sup>

The sentiment of the Taskforce is that the CFPB should, in general, direct its attention to greater use of principles-based regulation instead of rules-based regulation. In general, the CFPB should use its rulemaking power to provide a framework to be used in cooperation with its other tools, instead of viewing regulation as a single comprehensive final statement of its position on an issue.<sup>140</sup> Where appropriate, it may also combine principles-based rules with safe harbors to provide greater regulatory certainty for particular practices. The CFPB should be conscious of

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<sup>137</sup> A distinct question is whether the primary reason for a particular borrower’s default on payday loans reflects the borrower’s inability to repay the loan or a decision to rationally default and whether prescribing an ability-to-repay test would materially impact the default rate.

<sup>138</sup> To be sure, monitoring default rates might also have adverse consequences for consumers if it encourages lenders to be more aggressive in collections in order to reduce their default rates.

<sup>139</sup> See Bruno Leoni, *Freedom and the Law* (expanded 3<sup>rd</sup> ed., 1991). This uncertainty historically has been heightened in the case of the CFPB by its unique single-director structure and limited Congressional oversight, which tends to amplify swings from one Director to another, unlike agencies with multi-member commission structures, which tend to promote greater stability and more dampened swings in policy. See Zywicki, *Savior*, *supra* note 31. The decision by the United States Supreme Court in *Seila Law v. Consumer Financial Protection Bureau*, 591 U.S. \_\_\_, 140 S. Ct. 2183 (2020) that held that the Director of the Bureau is removable at the will of the President will likely amplify this tendency for large and more frequent swings in policy. See Stearns, Micelli, and Zywicki, *supra* note 69, at 734-750 (discussing dynamics of two-stage elections and implications for regulatory policy over time).

<sup>140</sup> For example, the Safeguards Rule of the FTC and the similar rules of the prudential regulators required covered entities to take steps that are reasonable in the circumstances to address security risks. Whether a particular step is necessary in a given set of circumstances must be resolved through enforcement or, in the case of the prudential regulators, supervision.

avoiding the production of overly detailed and overly prescriptive rules that constrict flexibility. Overly-prescriptive rules also quickly become obsolete and require chronic updating, producing cost and uncertainty.<sup>141</sup> Within this broad framework, enforcement can be seen as a primary tool of clarifying the application of those principles to specific fact situations and updating the applicability of those principles in light of technological, social, and economic change.

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

An additional potential mechanism for reducing uncertainty would be greater use of regulatory "safe harbors." Although the Taskforce recognizes the potential value of safe harbors in theory, the Taskforce is also wary of their overuse in practice. It is difficult to define the scope of a safe harbor in a principles-based fashion instead of an *ad hoc*, somewhat arbitrary carve-out. Because of their often arbitrary and unprincipled nature, *ad hoc* safe harbors can reflect the successful lobbying efforts of influential special interests more than any principled foundation. Moreover, just as rules-based regulation itself can tend toward encrustation, obsolescence, and difficulty in changing, safe harbors are often clearly defined rule-based exceptions and can have a similar effect. Once a safe harbor is created, it can be difficult to modify as circumstances change, in part because of the efforts of special interests to protect their preferred regulatory status. Thus,

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<sup>141</sup> The Taskforce's recommendations on the E-Sign statute illustrate the dangers of prescriptive rules that can lock-in prescriptive rules and impose unnecessary costs on consumers and industry.

<sup>142</sup> See Tarbert, *supra* note 134, at 6 ("Principles can be fleshed out by rules or other forms of guidance (both formal and informal) as appropriate).

<sup>143</sup> Bureau of Consumer Financial Protection, "Advisory Opinion Pilot" (June 16, 2020), available in [https://files.consumerfinance.gov/f/documents/cfpb\\_advisory-opinions-pilot\\_fr-notice.pdf](https://files.consumerfinance.gov/f/documents/cfpb_advisory-opinions-pilot_fr-notice.pdf).

<sup>144</sup> See Bureau of Consumer Financial Protection, "Statement of Policy Regarding Prohibition on Abusive Acts or Practices" (January 21, 2020), available in [https://files.consumerfinance.gov/f/documents/cfpb\\_abusiveness-enforcement-policy\\_statement.pdf](https://files.consumerfinance.gov/f/documents/cfpb_abusiveness-enforcement-policy_statement.pdf). As noted in the summary, the Statement was adopted "to convey and foster greater certainty about the meaning of abusiveness."

although the Taskforce recognizes the potential benefits of regulatory safe harbors as a potential response to heightened use of principles-based regulation, it also urges regulators to use initial care in drafting and enforcing their rules, rather than relying on safe harbors.

## 6.4.2 Enforcement

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

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

Equally important, enforcement is a poor tool to try to establish broad principles across an entire industry, as enforcement is focused on the acts of one party in one particular case. Given the narrow range of the issues raised by a particular case, regulation by enforcement lacks the rigor of the three-step process outlined above to identify and remedy market failures. Most obvious, sound regulation should be supported by rigorous cost-benefit analysis to ensure that overall consumer welfare will be improved by the regulatory action. Trying to establish broad principles through enforcement actions in a particular case or series of cases, by contrast, potentially end-runs protections to consumers provided by cost-benefit analysis and opportunities to comment on the proposed rule. As a result, when the benefits and costs of different approaches are in

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<sup>145</sup> See 12 U.S.C. §5511(c)(4).

dispute trying to set policy through enforcement instead of rules makes it difficult to consider and measure the full range of unintended consequences that may result from the action.<sup>146</sup>

The perils of trying to establish efficient quasi-regulatory rules through enforcement are heightened when the agency seeks to establish broad principles through precedents established through consent agreements rather than fully-litigated cases.<sup>147</sup> Most of the CFPB's enforcement actions, like many other government agencies, have been resolved by consent agreements and have not been fully litigated to judgment. By their nature, consent agreements generally provide only limited and largely one-sided conclusory information regarding the factual underpinnings of a case rather than a complete public record.<sup>148</sup> While the limited nature of the public record is not problematic in establishing the foundations for the application of liability and remedies in a particular case, it is less reliable when serving as a precedent for future enforcement actions. In addition, although consent agreements can provide some guidance as to what the agency considers illegal behavior in a particular case, unlike an adjudication before a judge, consent agreements do not provide any precedent or information about what is *not* illegal behavior. One practice adopted by some agencies to provide guidance as to behaviors that will not incur liability is to publish "Closing Letters," announcing the termination of an investigation without any allegation of illegality.<sup>149</sup> The CFPB should consider adopting a similar device to provide further guidance of types of practices that are thought to *not* be improper or investigations that are closed without action.

Moreover, unless rigorously monitored by senior management, trying to establish precedents through enforcement actions runs a risk of sending conflicting and inconsistent messages to regulated parties as to the substantive standards of liability and the damages and remedies that might assessed for violations. For example, testimony provided during the CFPB's Symposium on Abusive Acts and Practices expressed frustration with perceived uncertainty and unpredictability with respect to the CFPB's enforcement posture, both regarding the substantive definition of "abusiveness" in isolation as well as the relationship between "abusive" acts and practices on one

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<sup>146</sup> Consistent with this observation, the Taskforce recommends that major enforcement initiatives be subjected to retrospective review to estimate their overall effects on the market including unintended consequences, similarly to retrospective review of regulations.

<sup>147</sup> See Jan M. Rybníček and Joshua D. Wright, *Defining Section 5 of the FTC Act: The Failure of the Common Law Method and the Case for Formal Agency Guidelines*, 21 Geo. Mason L. Rev. 1287, 1293-97 (2014).

<sup>148</sup> In many instances, of course, the absence of a public record is at the request of the defendant, which is not problematic for resolving the case. It is problematic, however, when extrapolating the "precedent" of a settled case to new fact situations.

<sup>149</sup> See Federal Trade Commission, "Staff Closing Letters," available in <https://www.ftc.gov/enforcement/cases-proceedings/closing-letters-and-other-public-statements/staff-closing-letters>.

hand and unfair and deceptive practices on the other.<sup>150</sup> For example, reviewing CFPB's consent agreements in actions involving allegations of unfair, deceptive, and abusive behavior, it is difficult to discern a clear pattern as to how the CFPB has defined abusive behavior, as distinct from unfair and deceptive behavior. Many consent agreements seemingly defined abusive as more or less coterminous with unfair and/or deceptive practices, yet other cases with facially-similar fact patterns resulted in only counts for abusive behavior and still other cases only include allegations of unfair and/or deceptive practices.<sup>151</sup>

Given this uncertainty, the CFPB's Policy Statement on Abusive Acts and Practices is a useful step toward providing greater clarity and guidance on the Bureau's understanding of what constitutes "abusive" acts and practices. That sort of guidance is useful not only to reduce uncertainty to the regulated community but also to provide internal guidance to the CFPB staff to identify enforcement priorities and to allocate the CFPB's limited investigation and enforcement resources to target those behaviors that are most harmful to consumers and to ensure greater consistency across cases.<sup>152</sup> Moreover, as with rulemaking, uncertainty regarding the CFPB's enforcement posture can potentially deter acts, practices, and innovations that could be beneficial to consumers because of uncertainty as to how they will be viewed by the CFPB. As noted above, the CFPB's adoption of additional mechanisms for providing additional guidance, such as Advisory Opinions, No-Action Letters, and other guidance regarding its enforcement protocols and priorities, also have been useful to increase predictability and internal coherence and consistency in policy implementation.

Principles of preventing and remedying consumer harm while not discouraging beneficial conduct should guide the CFPB's approach to enforcement remedies. As with excessively broad or uncertain standards of substantive liability, excessive or unpredictable penalties for alleged violations can deter actions or the development of products and services that could provide benefits to consumers. To deter harmful behavior but not create excessive or unpredictable liability that could deter beneficial behavior, therefore, remedies should be predictable and should be grounded in consumer harm.<sup>153</sup> In order to gain optimal deterrence, the harm calculation should be adjusted upward to compensate for the probability that the harmful

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<sup>150</sup> See Bureau of Consumer Financial Protection, Statement of Policy Regarding Prohibition on Abusive Acts or Practices (Jan. 24, 2020) (summarizing testimony and conclusions of CFPB).

<sup>151</sup> See e.g. the statements of William MacLeod and Todd Zywicki at the CFPB Symposium on Abusive Acts or Practices, available at <https://www.consumerfinance.gov/about-us/events/archive-past-events/cfpb-symposium-abusive-acts-or-practices/>.

<sup>152</sup> See Statement of Todd J. Zywicki, Abusive Acts and Practices, *supra* note 128.

<sup>153</sup> See James C. Cooper and Bruce H. Kobayashi, *Equitable Monetary Relief Under the FTC Act: An Opportunity for a Marginal Improvement*, George Mason University Law & Economics Research Paper Series, 20-06 (March 2020), available in [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3549899](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3549899).



conduct will go undetected or unsuccessfully prosecuted.<sup>154</sup> Wherever relevant, grounding remedies in consumer harm also implies that any offsetting benefits that the consumer might have received should be considered as part of the economic damages that are recovered.<sup>155</sup> In reading many CFPB enforcement cases, it is not always evident how the CFPB arrived at the damages it seeks in particular cases or the degree to which the damages sought are grounded in consumer harm.

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

### 6.4.3 Supervision

A third tool possessed by the CFPB to carry out its mission is supervision.<sup>156</sup> Although government inspections are a common tool of consumer protection enforcement, the CFPB's authority to engage in ongoing supervision to the extent it does is unusual. Moreover, although supervision is quite familiar to depository institutions, it is somewhat novel for non-bank entities. The presence of a supervisory power for consumer protection purposes further reflects the unusual nature of the CFPB as a hybrid of a consumer protection and financial regulatory agency in using a conventional tool of prudential regulation to further the CFPB's mission of consumer protection.

The Dodd-Frank Act's rationale for providing CFPB with supervisory authority is unclear, and the precise objectives that supervision is designed to accomplish is also unclear. According to the Dodd-Frank Act, the purposes of supervision are to "assess[ ] compliance" with the law, obtain

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<sup>154</sup> *Id.* See also Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968); A. M. Polinsky and Steve Shavell, *Punitive Damages: An Economic Analysis*, 111 Harv. L. Rev. 869 (1998).

<sup>155</sup> See Cooper and Kobayashi, *supra* note 153.

<sup>156</sup> See 12 U.S.C. §5511(c)(4); 12 U.S.C. §5514 (providing supervisory authority over nondepository institutions); 12 U.S.C. §5515 (supervisory authority over banks, thrifts, and credit unions with more than \$10 billion in assets).

information about the activities and compliance systems of the entity, and to “detect[ ] and assess[ ] risks to consumers and to markets for consumer financial products and services.”<sup>157</sup> According to the Dodd-Frank Act, the primary purpose of nonbank supervision is “based on the assessment by the Bureau of the risks posed to consumers in the relevant product markets and geographic markets.”<sup>158</sup> The Dodd-Frank Act lists several considerations that the CFPB should take into consideration in making this assessment. Notably, however, the Dodd-Frank Act does not specifically instruct CFPB to make an explicit cost-benefit consideration in determining which institutions to supervise and how to conduct supervisory policy.

The Bureau’s supervisory authority is unrelated to the rationale for the traditional supervisory authority over banks by prudential regulators. Exercise of supervision by regulatory authorities over banks evolved into its current form in response to the implementation of the system of deposit insurance that began as part of the New Deal.<sup>159</sup> The availability of deposit insurance to protect small creditors of the bank (depositors) gives rise to a moral hazard problem, that the bank will have an incentive to hold insufficient reserves and take excessive risk. Supervision attempts to mitigate this moral hazard problem by monitoring the bank’s ongoing performance and risk-taking activities to ensure that the bank is not engaging in overly risky activity. Because lending risks are often difficult to observe externally, supervision provides a mechanism to prevent such behavior from occurring.

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

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<sup>157</sup> See 12 U.S.C. §5514(b).

<sup>158</sup> See 12 U.S.C. §5514(b)(2).

<sup>159</sup> See Eugene N. White, *Lessons from the History of Bank Examination and Supervision in the United States, 1863-2008*, in Financial Market Regulation in the Wake of Financial Crises: The Historical Experience 15, 16 (Alfredo Gigliobianco and Gianni Toniolo eds., 2009). White notes that although examination of banks have existed since the earliest days of the banking system, until the 1970s the primary purpose of examination for much of that time was to reduce the moral hazard problem by reinforcing market discipline and later as a mechanism for effectuating Federal Reserve monetary policy by controlling reserves and lending activity. The modern supervisory structure focused on bank safety-and-soundness arose in the 1970s in response to financial liberalization that exacerbated the moral hazard problem that had previously been controlled through strict regulation of bank’s activities. See also Donato Masciandaro and Maarc Quintyn, *The Evolution of Financial Supervision: The Continuing Search for the Holy Grail* 263, 267, in 50 Years of Money and Finance: Lessons and Challenges (Morten Balling and Ernest Gnan eds., 2013).

regulators. The “level playing field” idea that banks and nonbanks offering similar products should be subject to comparable levels of oversight may be part of the explanation in some cases, but it is simply not applicable to supervision of other entities, such as credit reporting agencies or debt collectors, that have never been in competition with banks. Nor is it obvious from the Dodd-Frank Act how its supervisory power should fit with the CFPB’s other more traditional consumer protection powers of regulation and enforcement.

Given this traditional justification for supervision, the purpose of granting supervisory power is even more puzzling with respect to non-bank lenders, such as small-dollar lenders that offer simple, largely homogeneous products to the public and for which harm is relatively easy to detect through consumer complaints. At the same time, the supervisory process can impose substantial costs and disruption on regulated parties in terms of preparing for and carrying out supervision visits. The supervision office of the CFPB also consumes a large number of resources, as it is the single largest office within the CFPB, employing almost 500 employees in total, with the vast majority of them situated in regional offices around the country, or about one-third of the entire CFPB staff headcount.<sup>160</sup> In light of the significant resource costs for both the CFPB and the regulated community of the supervisory process, the Taskforce encourages the CFPB to articulate more rigorously its overall objectives in using its supervision authority and thereby to estimate the relative costs and benefits of supervision as well as the different supervisory approaches and enforcement.

This absence of a clear purpose for the CFPB’s supervisory power is reflected in the CFPB’s rulemakings regarding “larger participants.” The Dodd-Frank Act does not establish clear criteria for the CFPB to use in to determine what constitutes a “larger market participant” across markets. In some instances the CFPB has interpreted its charge to focus on a firm’s financial receipts and in other situations the criteria is primarily the number of accounts they service.<sup>161</sup> Even where the same criteria are used to identify a larger participant, such as revenues, the amount varies from one market to another but it is not clear what criteria are used to draw the

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<sup>160</sup> The Enforcement division is the second-largest division within the Bureau, with about 150 employees. The divisions of Regulations, Research, Financial Education, and Markets all have fewer than 100 employees each. *See* Consumer Financial Protection Bureau Internal FY 2020-2021 Approved Staffing documents (Oct. 2020) (reviewed by Taskforce). In total, the Division of Supervision, Enforcement, and Fair Lending has 630 employees, which comprises approximately 43% of the CFPB’s total employee headcount of 1459.

<sup>161</sup> *Compare* Defining Larger Participants of the Consumer Debt Collection Market, 77 Fed. Reg. 65775, 12 CFR 1090 (Oct. 31, 2012) (“larger participants” are those with over \$10 million in receipts, excluding medical debts) *with* Defining Larger Participants of the Student Loan Servicing Market, 78 Fed. Reg. 73383, 12 CF 1090 (Dec. 6, 2013) (“larger participants” are those with more than 1 million active accounts), *with* Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile leasing Activity as a Financial Product or Service, 80 Fed. Reg. 37496, 12 CFR Parts 1001 and 1090 (June 30, 2015) (defining “larger participants” in nonbank auto finance market as those with at least 10,000 aggregate annual originations of auto loans or leases).

line.<sup>162</sup> The touchstone for the inquiry for drawing the threshold lines seems to be focused on ensuring that the CFPB supervises a sufficiently large number of firms to cover a large percentage of the market.

We do not suggest that the standards for “larger participants” should be identical across all markets, which obviously differ. Subjecting firms to supervision, however, involves a commitment of resources by the Bureau, resources that could be used elsewhere. The Bureau should think systematically about the allocation of its supervisory resources, and that thinking should be reflected in the underlying principles that guide “larger participant” rules. Yet the inquiry does not appear to rigorously assess the marginal benefits in terms to consumers in light of the marginal costs of exercising supervision, whether to regulated firms or in terms of internal resource allocation for supervision as opposed to other Bureau operations or supervision in other markets.

Another potential cost of the larger-market participant rule is the potential for “threshold effects” around the level established by the regulation. To the extent that being subject to supervision is effective in achieving compliance, crossing over the line that identifies a larger-market participant will increase the cost and risk associated with regulatory compliance as well as requiring investments in new expertise and compliance management.

Threshold effects have not been studied in the context of entities subject to “larger participant” rules, but they have been observed in banks. “Banks face a discontinuous increase in regulatory burdens as they cross these fixed nominal asset thresholds. As such, they may act to curtail their normal growth if that growth would put them just above a threshold.”<sup>163</sup> Anecdotal reports and some empirical data suggest that some financial providers in some instances might artificially limit their growth to avoid triggering this threshold; alternatively, in order to deal with the discrete jump in costs associated with going over the threshold can create incentives for banks to merge with a larger bank rather than continuing to grow organically in order to capture greater economies of scale in regulatory compliance costs.<sup>164</sup> Although these costs are inherent in setting

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<sup>162</sup> Compare Defining Larger Participants of the Consumer Debt Collection Market, *supra* note (\$10 million in receipts) with Defining Larger Participants of the Consumer Reporting Market, 77 Fed. Reg. 42873, 12 CFR 1090 (Sept. 30, 2012) (defining “larger participant” as those with “more than \$7 million in annual receipts from relevant consumer reporting activities”).

<sup>163</sup> David Hou and Missaka Warusawitharana, *Effects of Fixed Nominal Thresholds for Enhanced Supervision*, FEDS Notes (July 19, 2018), available in <https://www.federalreserve.gov/econres/notes/feds-notes/effects-of-fixed-nominal-thresholds-for-enhanced-supervision-20180719.htm>.

<sup>164</sup> See Shradha Bindal, Christa H.S. Bouwman, Shuting (Sophia) Hu, and Shane A. Johnson, *Bank Regulatory Size Thresholds, Merger and Acquisition Behavior, and Small Business Lending*, 62 J. Corp. Fin. 1 (2020); Hailey Ballew, Michael Iselin, and Allison Nicoletti, *Accounting-Based Thresholds and Growth Decisions in the Banking Industry*, \_\_\_ Rev. Accounting Studs. \_\_\_ (forthcoming 2020); Hou and Warusawitharana, *supra* note 163.

any regulatory threshold that results in a discrete increase in costs, in setting the threshold level, the CFPB should be conscious not to set the limit too low so that it artificially deters organic growth or encourages otherwise-inefficient mergers and should be diligent about updating those thresholds as needed, such as by adjusting any dollar value thresholds automatically according to inflation.<sup>165</sup>

## 6.4.4 Education and Financial Literacy

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

Consumer financial education, like other types of general education, has a public goods effects that make this an appropriate tool for a government agency, such as the CFPB, to provide. General domain consumer financial education has a complementary interaction effect with the provision of product-specific information and disclosures about products and providers. Consumer education and financial literacy aims at developing consumers' general competency in financial planning and decision making and enabling them to better protect themselves from harm. As discussed in Chapter 7, effective disclosure and provision of information about the terms and conditions of certain products helps consumers to make better decisions about particular products and services and to reward high-quality providers of financial services at the expense of low-quality providers. As a result, there is a complementary interaction between consumer education and literacy, as building increased capability in consumer financial decision-making and planning through financial education will increase the effectiveness of information provided about specific products and providers. Consumers with higher levels of general ability in consumer education and literacy should be able to shop more effectively and to make more effective use of information provided by mandated disclosures as well as advertising and other sources of information. No individual financial institution can capture all of the benefits associated with a more educated and financially literate consumers, there is a potential for underinvestment in those general problem-solving skills. As a result, effective financial education can be a legitimate function for government and the non-profit sector and can be a valuable tool to advance the CFPB's missions of consumer protection, competition, and inclusion.

Moreover, informed and educated consumers also provide external benefits to *other* less-informed consumers by making informed choices on markets by rewarding high-quality providers and driving low-quality providers out of the market. As a result, if sellers are unable to

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<sup>165</sup> See Hou and Warusawitharana, *supra* note 163.

easily distinguish between informed and uninformed consumers, then sellers will tend to compete at the margin for those consumers who shop more aggressively. This will tend to lead to the growth of higher-quality providers and higher-quality contract terms in competitive markets. More highly informed consumers can provide external benefits for consumers who are less informed and less sophisticated. To the extent that consumer preferences differ, competing bundles of terms will also emerge; that is the essence of product differentiation. Moreover, consumers who lack understanding of financial concepts can harm not only themselves but also might create negative externalities for other consumers and the economy. Financial distress has impact not only on the borrower but also other individuals as well. When a borrower is unable or unwilling to repay borrowed funds, those losses eventually must be passed on to other consumers. Taxpayers as a whole subsidize the bankruptcy system. As seen during the height of the late-2000s mortgage crisis, homes that fall into foreclosure can exert a negative impact on the value of neighboring properties.<sup>166</sup> Individuals who fail to save adequately for retirement will draw more heavily on public welfare programs than those who do save. Consumers with higher levels of financial education might be expected to be less likely to make decisions that lead to financial distress which will benefit both themselves and others.

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

It should be stressed, however, that although consumer education can be valuable in its own right and a useful complement to other regulatory tools, it is not a panacea for consumer harm nor is it a substitute for a robust public consumer protection enforcement and regulatory regime. The

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<sup>166</sup> Such externalities, however, seem to have been substantially overstated during the financial crisis. Research found that these “externalities” arose from reduced investments by distressed homeowners in the foreclosed property and tended to be short lived. Adoption of policies that slowed the resolution of the property from default to foreclosure increased the negative effect of mortgage distress on house prices. Still, default and eventual foreclosure cast a temporary shadow that depressed surrounding home prices. See Kristopher Gerardi, Eric Rosenblatt, Paul S. Willen, and Vincent Yao, *Foreclosure Externalities: Some New Evidence*, 87 J. Urban Econ. 42 (2015).

value of financial literacy as a regulatory objective should be assessed with a realistic appraisal of both its potential value and its limits. Consumers face constraints on their time and attention, which limits their patience for developing consumer literacy tools. As discussed in Chapter 12, like other types of education, financial knowledge tends to depreciate without recurrent use and reinforcement. More important, many consumer financial products are inherently complex and difficult to understand. Most of this complexity is inevitable in the provision of financial products—credit cards, for example, are used for many different functions, including transactions, borrowing, online shopping, security, and many others. Given the varied uses of credit cards, there is a certain irreducible minimum level of complexity. Mortgages are also highly complex, partly because of the inherent complexity and risks of the product but also because of a complex web of regulatory-induced complexity. As discussed in Chapter 7, consumers are bombarded with information and disclosures regarding the goods and services that they consume. All of this means that even the most-informed and diligent consumer is unlikely to be able to read and understand all of the details of all of the financial products (and other products) that they encounter and will be unable to protect themselves from all fraudulent activity. Thus, while financial literacy provides a first line of defense against illegal practices and a catalyst for competitive markets, it should be seen as having a role first in making markets work more effectively for consumers and also for complementing other tools and making them more effective.

#### 6.4.5 Policy Research and Development

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

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

The research function of agencies has been referred to as “policy research and development” because of its foundational role in providing direction and mission to an agency, to help it identify the greatest opportunities and threats to consumer financial welfare.<sup>167</sup> As former FTC Chairman William Kovacic has noted, the label takes its inspiration from the observation that “These are public sector capital investments that resemble the R&D outlays that a company makes to improve the range or quality of its ‘products.’”<sup>168</sup> Kovacic notes that one of the values promoted by policy R&D investments is the creation of “economic precedents,” i.e., studies that can evaluate the validity of a hypothesis that can be later relied upon in assessing the wisdom of a proposed policy intervention.<sup>169</sup> Rigorous performance measurement and evaluation of previous interventions can also provide feedback for improved policymaking. As the Federal Trade Commission noted a decade ago, “An agency that intends to be thoughtful and to consider its policy actions seriously must have some ability to analyze the trade-offs inherent in any policy choice.”<sup>170</sup> Policy R&D takes on a heightened importance at the CFPB in light of the reality that policy-oriented research related to consumer finance has not been in vogue among academic economists in recent decades.

To be useful, however, it is important that any analysis be independent from the agency’s staff that has contributed to or is otherwise invested in the substantive policy. In this vein, the Taskforce commends the CFPB’s Office of Research for its recent announcement of a new procedure for external peer review of important Bureau research.<sup>171</sup> The CFPB should consider extending cost-benefit analysis to its enforcement actions as well even if such analysis would be less precise than for rules. Nevertheless, because enforcement actions typically do not have any rigorous analysis of tradeoffs as part of the process—unlike rulemaking, in which policy R&D and cost-benefit analysis are embedded in the decision-making process itself—it is essential for the CFPB to be proactive in conducting research to ensure that its actions are on net beneficial to consumers.

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<sup>167</sup> See William E. Kovacic, *Measuring What Matters: The Federal Trade Commission and Investments in Competition Policy Research and Development*, 72 *Antitrust L.J.* 861 (2005); see also Timothy J. Muris, *Looking Forward: The Federal Trade Commission and the Future Development of U.S. Competition Policy*, 2003 *Colum. Bus. L. Rev.* 359 (2003).

<sup>168</sup> Kovacic, *supra* note 167, at 862.

<sup>169</sup> *Id.* at 865.

<sup>170</sup> Federal Trade Commission, *The Federal Trade Commission at 100: Into our 2<sup>nd</sup> Century, The Continuing Pursuit of Better Practices* at p. xiii (Jan. 2009).

<sup>171</sup> See Jason Brown, Consumer Financial Protection Bureau, *Bureau Adopts New Procedures for External Peer Review of Important Research*, CFPB.gov (Aug. 28, 2020), available in <https://www.consumerfinance.gov/about-us/blog/bureau-adopts-new-procedures-external-peer-review-research/>.



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

As an adjunct to its research function, the Taskforce believes that the CFPB should consider adding an “Advocacy” function to its consumer protection toolkit. Under this approach, the CFPB can bring its expertise to bear to advise other agencies, state and federal policy-makers, and judges about the likely consequences of their actions for consumer welfare, including the effects on competition and inclusion.<sup>172</sup> Few other government offices have the potential depth and breadth of knowledge about consumer financial protection and innovation the CFPB has with respect to the matters under its scope. Advocacy can be particularly important with other financial regulators, which tend to have narrower constituencies than does the Bureau. The CFPB’s can be particularly helpful in this area where other governmental actors are considering taking actions that would be harmful to innovation or competition that would raise prices and reduce choices for consumer. Many proposals clothed in the garb of “consumer protection” are instead promoted by interest-groups to protect themselves from competition. The CFPB’s expertise and independence provides with the authority to explain why facially attractive ideas such as usury controls could have adverse unintended consequences for consumers.

#### 6.4.6 Internal Reorganization and Effective Use of Regulatory Tools

As should be clear from this discussion, regulatory tools are a means to the end of maximizing consumer welfare broadly described to include consumer protection, inclusion, competition, and innovation. Since its inception, the divisions of the CFPB have been organized primarily around its several regulatory tools, in addition to its enumerated statutorily-mandated offices and other

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<sup>172</sup> See Federal Trade Commission, *supra* note 169, at xvi; see also James C. Cooper, Paul A. Pautler, and Todd J. Zywicki, *Theory and Practice of Competition Advocacy at the FTC*, 72 Antitrust L.J. 1091 (2005).

functions.<sup>173</sup> With respect to its tool usage, the CFPB has a division of Supervision, Enforcement, and Fair Lending (containing within it Offices of Enforcement, Supervision Policy, and Supervision Examinations). and a division of Research, Markets & Regulation, with Offices of Research, Regulations, and three markets-related Offices (Consumer Credit, Payments, and Deposit Markets; Mortgage Markets; and Small Business Lending Markets). Thus, for example, all regulations are drafted in the Office of Regulation, regardless of the subject matter. And although the Office of Regulation is within the same division as the Offices of Research and relevant markets, it bears no formal structural overlap with, for example, the Offices of Supervision or Enforcement.

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

The tool-based organizational structure of the CFPB can lead to some potential difficulties in decision-making. Most important, by organizing around tools instead of markets, the current structure of the CFPB makes it difficult to ensure that the optimal combination of tools is being used to protect consumers and promote competition and inclusion at the lowest cost. This can result in some degree of tunnel vision that has prompted some of the more frequent criticism of the Bureau's operation. Most notable, the CFPB was criticized for its perceived practice of "regulation by enforcement," i.e., using individual cases, particularly negotiated consent agreements, to try to impose industry-wide practices on market participants while circumventing the protections provided by the notice and comment rulemaking procedure and subsequent judicial review under the Administrative Procedure Act. Even when the potential concerns of other divisions are taken into account, outside of the context of an understanding of the market, they may result in inferior policy choices. Principles-based rules, for example, are likely more challenging for examiners to apply and may introduce litigation uncertainties, but as discussed above, such approaches are generally preferable to detailed prescriptive requirements. A staff

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<sup>173</sup> The Bureau has four statutorily mandated offices, including the Office of Financial Education, the Office of Fair Lending and Equal Opportunity, the Office of Service Member Affairs and the Office of Financial Protection for Older Americans. The Bureau also has several ancillary and support functions, including external affairs, legal affairs, and consumer response. These offices are essential to carry out the Bureau's statutory mission but do not raise analytical questions with respect to their organization for the Taskforce to consider.

with expertise in the market is better positioned to assess the tradeoffs. Thus, in some instances, CFPB rules have been extremely detailed and prescriptive. For example, in the 2017 Small-Dollar Loan Rule, the Bureau not only required the industry to evaluate a consumer's ability to repay the loan, it dictated a particular formula for doing so, thereby preempting potentially superior or proprietary systems. It is possible that internally organizing the CFPB around markets and products, instead of tools, could avoid the tendency for each division to tend to overvalue its own particular tool as providing a comprehensive response to every consumer protection problem.

Moreover, under the current structure it is difficult for any employee or division to develop deep, ongoing familiarity with the developments in any particular market. By combining enforcement and rulemaking (including more informal acts such as guidance or policy statements) within a particular division, it becomes more efficient to determine how certain rules are operating in practice and where they might need clarified. It would also make it easier to use tools in a complementary fashion, such as to use principles-based rulemaking (in which the particular division is highly familiar with the principles that animated the rule) to be fleshed out through supervision, enforcement, and other issues. In addition, by linking research functions more closely to particular markets and consumers, the Bureau could be better able to anticipate emerging questions in various markets and to do conduct timely policy-relevant research and to prioritize research projects within the division. In short, by organizing around markets instead of tools, the various divisions could develop deeper subject-matter expertise as well as to adjust their mix of tool usage as time goes on.

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

The difficulties that can arise from the current CFPB structure is highlighted by the peculiar division of authority with respect to the Bureau's larger market participant rules. As discussed, one difficulty with the Bureau's definition of large market participants is that it is difficult to

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<sup>174</sup> Clarke and Zywicki, *supra* note 32.

determine in the abstract what constitutes a larger market participant and where to draw the threshold line to distinguish those institutions that should be subject to ongoing supervision from those that should not. Moreover, once that line is drawn, there remains the question as to whether it has been drawn according to the correct criteria (to maximize consumer protection and lowest cost to providers and consumers) or in the correct place. Presumably, those rules should be subject to ongoing consideration and perhaps regular formal updating as the Bureau develops new information about the wisdom of the current practice and whether new product markets and providers should be supervised. This information as to whether the criteria or threshold should be adjusted would be most likely to emerge from ongoing communications with the regulated industry, enforcement actions, and research as to emerging threats and developments in the market. This suggests a feedback loop between the costs and benefits of supervision under its current configuration, its complementary operation with enforcement, research as to its relative costs and benefits compared to other tools, and feedback into whether the rule itself should be revised or whether new rules should be issued for new products.

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

The Taskforce recognizes that reorganizing the Bureau around markets instead of tools would raise new challenges. The division between markets will not always be clear. Organizing operations around markets also will not entirely eliminate the challenges of cross-Bureau coordination: it will simply raise new challenges of coordination across markets instead of coordination across tools. Still, the Taskforce believes that the potential benefits of reorganizing around markets in terms of deepening expertise and increasing the effectiveness of tool usage outweighs these potential coordination costs. For example, although it is possible that over time some inconsistencies could arise in the interpretation of, say, the “unfairness” standard as applied to debt collectors versus credit card issuers, it is the view of the Taskforce that consistent application to all of the competitors in a given market is particularly important—whether articulated as part of rulemaking, supervision, or enforcement. Assuring consistent application of the underlying legal standards across markets is an easier task for the General Counsel and the Director’s Office than is assuring consistent advice and direction to competing firms.

Finally, as a further element of this effort to make its use of regulatory tools more effective, the Taskforce also recommends the creation of a new unit within the Bureau to coordinate cross-bureau operations and assessment. This unit could perform a variety of functions. The existing Office of Strategy could be relocated into this unit as part of the Bureau’s comprehensive strategic planning and assessment operations. This unit could also serve as an institutional location to

coordinate for important bureau objectives that cut across its various tools and markets, such as the initiatives and programs of the Office of Innovation and promotion of the Bureau's statutorily-mandated mission to promote competition in consumer finance markets. This new unit could be the location of an independent internal cost-benefit analysis functionality operating in collaboration with similar offices within the divisions. This unit could serve as the location for a new competition and consumer protection advocacy function for the Bureau to provide advice to state and federal regulators regarding policies to effectively protect consumers and promote competition, innovation, and access in consumer financial markets. This unit could be tasked with special projects, such as retrospective review of major enforcement efforts to determine their efficacy and efficiency. Finally, and most relevant for the current discussion, this unit could be responsible for promoting internal coherence and consistency of policies and priorities throughout the Bureau's various actions and activities.

## 7. Information and disclosure

A central pillar of the National Commission on Consumer Finance's (NCCF) focus was empowering consumers through the provision of information in a standardized, user-friendly format. This interest of the NCCF in the topic of information provision was not merely a coincidence—the NCCF itself was created by the Consumer Credit Act of 1968, the same legislation that enacted the Truth in Lending Act (TILA). According to the NCCF, providing consumers with the opportunity to have “full knowledge of [their] credit transactions” was central to the process of enabling consumers to protect themselves against overreach by providers and to “assure that competition is meaningful.”<sup>1</sup>

The federal role in financial consumer protection began with an information problem. Subject to state regulation under different statutes and regulatory structures for different institutions, lenders stated the interest rate on their products in a variety of manners that greatly complicated comparisons, particularly across different institutions from which a consumer might seek credit. As noted by the NCCF, prior to the enactment of TILA, state laws varied widely in their disclosure requirements, frustrating the efforts of consumers to meaningfully shop among different providers. In particular, “the greatest lack of uniformity was in the quotation of the amount and rate of the finance charge.”<sup>2</sup> Under the Uniform Small Loan Law advocated by the Sage Foundation, lenders disclosed an effective interest rate that included all credit costs and applied to the declining loan balance. Morris Plan or industrial banks expressed rates as a discount rate plus fees. For a \$100 loan at 6 percent discount plus \$2 in fees repaid over the course of a year, the cost as a percentage of the average loan balance would be over 17 percent. Retailers used an “add on” rate, where credit charges were added onto the cash price of the merchandise. A \$100 purchase at a 6 percent add-on rate would cost \$106 over 12 months.<sup>3</sup> As a result, it was “almost impossible” for consumers to compare offers across industries.<sup>4</sup> As the NCCF noted, “As a result of these varying forms of quoting the rate of charge, consumers could often compare rates among lenders in one class, such as commercial banks, but seldom

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<sup>1</sup> National Commission on Consumer Finance, *Consumer Credit in the United States* 4 (1972).

<sup>2</sup> NCCF Report, *supra* note 1, 169.

<sup>3</sup> See Anne Fleming, *The Long History of “Truth in Lending”*, 30 J. Pol’y Hist. 236-271 (2018).

<sup>4</sup> NCCF Report (1972), *supra* note 1, 170.

between classes of lenders, such as credit unions and commercial banks.”<sup>5</sup> This lack of consistency in state laws “helped create a climate favorable for legislation requiring uniform quoting of rates of charge.”<sup>6</sup>

Prior to TILA, consumers reflected a low degree of understanding and awareness of the actual cost of credit, especially in comparing offers of different amounts and maturities.<sup>7</sup> As part of its proceedings, the NCCF authorized two studies to determine the initial effectiveness of TILA.<sup>8</sup> In the period immediately following the enactment of TILA and the publication of the NCCF’s Report, the Commission concluded that the enactment of TILA had increased awareness by consumers of the APR on loans.<sup>9</sup> Increased awareness among consumers was not uniform, however, as consumers with lower education levels and income, minorities, and renters exhibited lower awareness levels of APR. Moreover, the persistence of retailers as leading credit providers, and their tendency to reprice credit terms into the price of goods purchased, undermined the usefulness of APR disclosure in sales credit.<sup>10</sup> Because the use of sales credit was much greater in higher-risk markets than in the general market, this lack of transparency in sales credit exacerbated the already-existing challenges for these groups to grasp the full price of credit transactions.<sup>11</sup>

Truth in Lending addressed this lack of comparability with a standardized “all in” cost measure, the annual percentage rate. The APR has become a widely recognized shopping tool for consumers, and along with other developments has helped enhance competition in consumer credit markets. As discussed in more detail in Chapter 8, this increased competition has greatly benefited consumers. The standardized disclosure of an effective interest rate including all credit costs in Truth in Lending has thus been an important success story in federal consumer financial protection. As Durkin and Elliehausen note, “TILA and the other information-based protections undoubtedly have encouraged these trends [toward greater competitiveness] in

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<sup>5</sup> NCCF Report (1972), *supra* note 1, 170.

<sup>6</sup> NCCF Report (1972), *supra* note 1, 170

<sup>7</sup> See NCCF Report (1972), *supra* note 1, 170.; see also F. Thomas Juster and Robert P. Shay, Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation (1964).

<sup>8</sup> Robert P. Shay and Milton W. Schober, Consumer Awareness of Annual Percentage Rates of Charge in Consumer Instalment Credit: Before and After Truth in Lending Became Effective (1972); George S. Day and William K. Brandt, A Study of Consumer Credit Disclosures: Implications for Present and Prospective Legislation (1972).

<sup>9</sup> See NCCF Report (1972), *supra* note 1, at 175-179.

<sup>10</sup> See NCCF Report (1972), *supra* note 1, at 180-182.

<sup>11</sup> As discussed in chapter 10, the higher rate of usage of sales credit by higher-risk households during this period resulted as a by-product of usury ceilings, which led retailers to increase the price of the goods they sold to offset their inability to charge a market rate for credit.

consumer-oriented credit markets, at a minimum by standardizing much lending terminology and making it more familiar to diverse consumers.”<sup>12</sup>

Conceptually, disclosure is a more attractive approach to consumer protection than is substantive regulation of financial products and services because it respects consumer preferences and allows for the different circumstances of different consumers. Substantive regulation must either limit all consumers to essentially the same product, or establish criteria for determining who is eligible for which product. Even product features that may seem highly suspect in most circumstances, such as no- or low-documentation loans, have their place in serving consumer needs, as numerous consumers who are self-employed or gig workers have discovered. Such income is very difficult to document in a way that is both reliable and predictive of future income.

The apparent success of Truth in Lending spawned a wave of ever more comprehensive, and complex, disclosures. Truth in Lending itself has grown far beyond the original proposal to disclose two items, the APR and the finance charge. Other statutes requiring extensive disclosures have also proliferated, including the Consumer Leasing Act, the Real Estate Settlement Procedures Act, the Truth in Savings Act, and the Electronic Fund Transfer Act to name a few.<sup>13</sup>

These disclosure requirements are all part of an effort to make sure consumers do not make financial product decisions based on “incomplete” information. “Complete,” of course, is never defined, which is part of the reason disclosures have expanded. There is always something more that can be disclosed, and when it is brought to the attention of policymakers, it has been added to the required disclosures. In many respects, as we discuss in detail in this chapter, this pursuit of complete information is an endless pursuit of a mirage. There is no oasis at the end of the journey.

We all make dozens, if not hundreds, of decisions every day without consciously thinking or benefiting from complete information. It is not because we fail to recognize that additional information or deliberation might improve our choices. Rather, it is because finding and using information is costly—it consumes some combination of time, money, and, perhaps most important, attention. Making decisions, even complex and potentially consequential financial decisions, with incomplete information is the rational, and optimal, choice for any consumer. Even simplified decision rules, such as focusing on the one element of a transaction that is most

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<sup>12</sup> THOMAS A DURKIN AND GREGORY ELLIEHAUSEN, TRUTH IN LENDING: THEORY, HISTORY, AND A WAY FORWARD, Table A.1, p. 178 (2011).

<sup>13</sup> DURKIN AND ELLIEHAUSEN (2011), *supra* note 12. A comprehensive listing – 14 pages long -- of required financial market disclosures for consumer is in Appendix Table A.1.



important to an individual consumer, can be the most rational choice. Nevertheless, the common regulatory response to the observation that consumers are not using certain information that someone believes should be used is to require disclosure of that information. Disclosure requirements have grown substantially over time, resulting in a complex web of detailed disclosures that is a compliance labyrinth for regulated entities and of questionable value as a means of protecting consumers or better informing consumers' decisions.

There is nothing particularly unique about consumer financial decisions. All consumer decisions depend on information, and that information is gathered and utilized in the same fashion for any consumer product. Some financial decisions are complex, but so are many other consumer purchasing decisions. We recognize that consumers of automobiles or computers make perfectly adequate decisions concerning how much information to obtain about the best product to buy, and which features are worth the cost. Deciding where to live and what kind of house to buy is certainly a complex decision, but we rely on consumers to do an appropriate amount of shopping and make reasonable choices. Then the flurry of required disclosures for financing the transaction becomes a blizzard of paper.

This chapter explores the related issues of the costs of information, markets for information, including seller-provided information, and how consumers use and process information. The chapter also discusses disclosure and the difficulties of effective communication.

## 7.1 The Economics of Information

One of the simplifying assumptions in the textbook model of perfect competition is that all participants have complete information. Although this simplification yields important insights, it obviously does not describe reality. Instead, many economic decisions are made with incomplete information. If consumers lack information about product benefits, they may undervalue the product and not consume as much as they would with more complete information. A more common regulatory concern is that consumers may lack information about drawbacks of a product, in which case they may overvalue it and consume more of it than they would otherwise. If consumers lack information about competing offerings, sellers have at least some market power because they will not lose all their business as a result of a higher price or lower quality.

In fact, among the many decisions that market participants must make are choices about how much information to acquire. Although concerns about imperfect information have a long history, the economics of information was formalized in an influential article by George Stigler

in 1961.<sup>14</sup> Stigler argued that consumers would benefit from the search for information until the marginal benefits of additional information were just equal to the marginal cost of gathering more data. Information costs contribute to differences in prices and product characteristics across sellers because, although consumers will gather enough information to find a product they are willing to purchase, they will not incur the costs of considering all possible options. Other authors have termed this phenomenon “rational ignorance.”<sup>15</sup> The more it costs to obtain additional information, and the smaller the benefits of additional information, the more rational consumers will choose to remain uninformed. Reducing ignorance is simply not worth the costs.

The particular problem that Stigler considered was searching for a lower price, but the result is easily generalizable. The benefit of information is the savings from the possibility of finding a lower-price seller or an offering that is better in some other respect. The cost is the time and effort of gathering information from another seller. As discussed below, information may be acquired through purchase, through the expenditure of time and effort, or from the consumer’s past experience. Regardless of how it is obtained, however, information consumes attention.<sup>16</sup> We cannot pay attention to everything, and at some point consumers will decide that they would rather pay attention to family, friends, and the things that make life worthwhile rather than nailing down the facts about one more detail of a potential transaction.

Because finding and using information is costly, consumers must choose which information to seek out. Unsurprisingly, they pay more attention to information about the product features that matter most to them. For example, consumer surveys find that credit card users who almost always pay their balance in full are less aware of the APR and are less likely to check the APR on their statement every month than consumers who sometimes or hardly ever pay in full. Consumers who usually pay in full are much less likely to actually pay finance charges. In contrast, users who sometimes or hardly ever pay their full balance are facing the costs of credit, are more aware of the APR, and are more likely to consider the APR on their statement each month.<sup>17</sup> Similarly, the main reason consumers who usually pay in full opened a new account was to obtain rewards; those who carry a balance did so to make a specific purchase or to rebuild or increase their credit.<sup>18</sup>

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<sup>14</sup> George J. Stigler, “The Economics of Information,” 69 J. Pol. Econ. 213-213 (1961).

<sup>15</sup> Anthony Downs, *An Economic Theory of Democracy* (Harper) (1957)

<sup>16</sup> Herbert A. Simon, *Designing Organizations for an Information Rich World*, in In M. GREENBERGER (ED.), *COMPUTERS, COMMUNICATIONS, AND THE PUBLIC INTEREST* (1971).

<sup>17</sup> Glenn B. Canner and Gregory Elliehausen, *Consumer Experiences with Credit Cards*, 99 FEDERAL RESERVE BULLETIN 1-36, 22-23 (2013).

<sup>18</sup> Canner and Elliehausen (2013), *supra* note 17.

Even with costly information, markets can produce competitive outcomes. Some consumers will be informed, whether about price or product characteristics. As long as the informed group is sufficiently large to be worth competing for, their search for information will police the marketplace.<sup>19</sup> Because sellers usually cannot easily discriminate between informed and uninformed consumers in most circumstances, they must offer a competitive price (or competitive terms on other product dimensions) if they wish to compete for the informed buyers.<sup>20</sup> With enough informed buyers, the equilibrium outcome will be the competitive equilibrium, even though many buyers choose not to be informed.

Of course, given the importance of the costs of obtaining information, government actions that reduce the cost of information can improve market performance in maximizing consumer welfare. Standardized measuring systems that facilitate product comparisons, for example, can ease the consumer's task of obtaining information and enhance competition on the measured dimension.<sup>21</sup> As discussed below, this has been the major accomplishment of the Truth in Lending Act, which established the APR as a standardized measure of the cost of credit in consumer credit transactions.

## 7.2 Seller-Provided Information

Sellers' advertising and other forms of marketing combine for one of the most important sources of information for consumers. The substantial investments that firms make in advertising are best understood as efforts to provide information to consumers. As George Stigler noted, "advertising is an immensely powerful instrument for the elimination of ignorance."<sup>22</sup>

Seller incentives to provide positive information about their products are obvious. There is also a clear incentive to select the information that is of greatest use to the consumer—the

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<sup>19</sup> Alan Schwartz, A. and Louis L. Wilde, "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis," 127 U. PA. L. REV. 630-682 (1979).

<sup>20</sup> Shopping occurs even for the terms of standard form contracts. See, e.g., Howard Beales and Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 21 J. CORP. FINANCE: CONTRACTING, ORGANIZATION AND GOVERNANCE, 157-198 (1995) (Evidence addressing shopping for standardized franchise contracts). See also Barth, J.R., J.J. Cordes, and A.M.J. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J. LAW & ECON. 357-380 (1986). (Evidence of shopping for personal loan terms). The critical role of marginal consumers in determining the competitive market outcome is discussed in more detail in Howard Beales, *Consumer Protection and Behavioral Economics: To BE or Not to BE?*, 4 COMPETITION POLICY International 149-168 (2008).

<sup>21</sup> Howard Beales, Richard Craswell, and Steven Salop, *The Efficient Regulation of Consumer Information*, 24 J. LAW & ECON. 481-539 (1981).

<sup>22</sup> Stigler, *supra* note 14.

information that is most likely to influence consumers' choices. In some cases, such as regulations mandating standardized measurement systems, a disclosure requirement may motivate advertising of useful information. As discussed in more detail below, however, disclosure requirements can effectively increase the costs of providing useful information. In such cases, a disclosure requirement may discourage useful information and motivate sellers to talk about something else.

Generally, information has a greater impact on markets when it is disseminated voluntarily, and in response to consumer demand.<sup>23</sup> With or without disclosure requirements, the effect of information stems from the fact that sellers use information to compete on product characteristics that consumers care about. And, of course, sellers have incentives to tell consumers about product characteristics they may not know about and explain why they should care. Fat and fiber content were frequently disclosed on nutrition labels, but it was advertising addressing the health benefits of diets higher in fiber<sup>24</sup> and lower in fat<sup>25</sup> that led to significant changes in consumption. It is not disclosure requirements that make it easy to locate products that are kosher or halal or organic, because there are none; it is rather the self-identification of such products in response to consumer demand.

If information markets are to work efficiently, the information they provide must be accurate and reliable. Absent some check, a seller's incentive to overstate the advantages of their offering is straightforward. Intervention to prohibit false or deceptive advertising is therefore essential.

Government intervention, however, is not the sole force for honesty in the marketplace. Many financial services, including credit cards, deposit accounts, and prepaid cards, are likely experience goods, where a consumer can evaluate the quality of the service after using it.<sup>26</sup> Profitability depends on customer retention. Dissatisfied customers are not likely to remain for long. If consumers are misled into purchasing a service that does not deliver as advertised, they are likely to be dissatisfied, and leave. For the same reason, the mere fact that a firm advertises

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<sup>23</sup> This assumes that there are measurements that allow comparison of competing products. See, Beales, Craswell and Salop, *supra* note 21. The market-enhancing impact of Truth in Lending occurred precisely because it provided such a measure.

<sup>24</sup> Pauline Ippolito & Alan Mathios, *Health Claims in Advertising and Labeling: A Study of the Cereal Market*, FTC STAFF REPORT (1989), available at <http://www.ftc.gov/be/econrpt/232187.pdf>.

<sup>25</sup> Pauline Ippolito & Alan Mathios, *Information and Advertising Policy: A Study of Fat and Cholesterol Consumption in the United States, 1977–1990*, FTC STAFF REPORT (1996), available at [http://www.ftc.gov/be/consumerbehavior/docs/reports/IppolitoMathios96\\_fat\\_long.pdf](http://www.ftc.gov/be/consumerbehavior/docs/reports/IppolitoMathios96_fat_long.pdf).

<sup>26</sup> Phillip Nelson, *Information and Consumer Behavior*, 78 JOURNAL OF POLITICAL ECONOMY 311–329. (1970) (distinguishing between search characteristics and experience characteristics). As with other information, experiential evaluation of quality is often incomplete, focusing on the characteristics that are most important to the consumer. Nonetheless, market outcomes can be competitive.

is a source of information about product quality. When sellers depend on repeat purchases, they can signal their quality with investments in advertising.<sup>27</sup> These investments only yield a return if consumers continue to buy the product. Investments in advertising thus act as a bond, which the firm will lose if poor performance leads consumers to stop purchasing the product. Such investments are an important market incentive to ensure that firms provide what they promise.<sup>28</sup> Similarly, a seller's reputation is an intangible asset that is at risk from misleading practices, providing an important incentive for honesty and fair dealing.<sup>29</sup> In a survey asking credit card consumers what factors were important in their decision to get their card, the seller's reputation was second only to card acceptance by merchants, in closed-ended questions, and more often mentioned than interest rates or fees.<sup>30</sup>

Of course, many financial products, such as mortgages, are not frequently purchased. Although the mortgage lender may hope to market other products and services to a borrower, repeat purchases are a less effective market pressure than in the case of frequently purchased items. In the case of mortgages, however, consumers usually have access to independent sources of information who may have repeated experience with a particular lender and know the lender's reputation. As discussed below, most home buyers use a real estate agent, who is likely knowledgeable about financing options. Thus, reputational incentives continue to constrain the lender's behavior. Still other financial products, such as investment advice, are what economists call "credence goods,"<sup>31</sup> where quality cannot be evaluated even after the fact, and where other experts may disagree about quality. Even in these cases, however, theoretical analyses find that market outcomes are efficient as long as either quality is verifiable or providers are liable for poor quality.<sup>32</sup>

One of a seller's key incentives is therefore to satisfy its customers, and to provide the kind of information that will attract customers who will remain with the business. In marketing credit cards, for example, one source reports a rule of thumb that booking a new account costs \$275.

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<sup>27</sup> Phillip Nelson, *Advertising as Information*, 82 JOURNAL OF POLITICAL ECONOMY, 729-754 (1974).

<sup>28</sup> Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 JOURNAL OF POLITICAL ECONOMY 615-641 (1981).

<sup>29</sup> See Armstrong, M., *Interactions between Competition and Consumer Policy*, 4 COMPETITION POLICY INTERNATIONAL 97-148. (2008). See also Paul Rubin, *Regulation of Information and Advertising*, 4 COMPETITION POLICY INTERNATIONAL 169-193 (2008).

<sup>30</sup> CONSUMER FINANCIAL PROTECTION BUREAU, ARBITRATION STUDY: REPORT TO CONGRESS, 3-14 (2015).

<sup>31</sup> M.R. Darby and E. Karni, *Free Competition and the Optimal Amount of Fraud*, 16 JOURNAL OF LAW & ECONOMICS, 67-88 (1973).

<sup>32</sup> U. Dulleck and R. Kerschbamer, *On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods*, 44 J. ECON. LIT. 5-42 (2006).

That account will be profitable only if consumers continue using the card. Attrition rates on credit card accounts are about 15 percent.<sup>33</sup> A card provider, therefore, needs to offer features that consumers want, and inform consumers about those features. If not, consumers will simply leave. The Consumer Financial Protection Bureau’s study of arbitration clauses found that if a credit card issuer refused to refund a fee that the consumer had not agreed to, 57 percent of consumers would close the account.<sup>34</sup> Because they are aware of this consumer behavior, banks often offer refunds of unexpected or disputed fees when consumers complain. One Texas bank offered refunds in two-thirds of cases in which a consumer complained.<sup>35</sup> It is simply not worth alienating otherwise profitable customers over disputed fees.

The need for repeat business also drives marketing choices about which information to provide. Because different consumers use credit cards differently, card issuers have an incentive to develop marketing materials that seek to attract the right consumer to the right card. Consumers who pay their balances regularly are likely to be far more interested in rewards for card use and unconcerned about the interest rate. Consumers looking to roll over an existing balance are likely to be far more attuned to the rate and less concerned about other card features. Consumers are quite able to make appropriate choices: In an experiment by a large bank that offered a choice between a card with an annual fee and a lower interest rate or a higher rate with no fee, on average consumers made the cost-minimizing choice. Of course, some consumers made mistakes, but they corrected those mistakes, especially when the errors were large.<sup>36</sup>

Seller willingness to provide information that consumers value is apparent in the marketing of many financial services, even where information is not required. Many providers offer features such as low-balance alerts that are designed to help consumers avoid fees. Others offer apps to monitor credit card transactions for common errors such as a transaction mistakenly submitted twice or a wildly disproportionate tip.

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<sup>33</sup> Brian Riley, *New Credit Card Accounts Up but Volumes Remain Flat*, PAYMENTS JOURNAL (2018). Available at <https://www.paymentsjournal.com/new-credit-card-accounts-volumes-remain-flat/>. Actual data on the cost of acquiring new accounts is closely held information in the industry.

<sup>34</sup> CFPB (2015), *supra* note 30.

<sup>35</sup> Jason Scott Johnston and Todd Zywicki, *The Consumer Financial Protection Bureau’s Arbitration Study: A Summary and Critique*, Mercatus Working Paper, Mercatus Center at George Mason University, at 32 (2015).

<sup>36</sup> Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts*, 4 REVIEW OF CORPORATE FINANCE STUDIES 239-257 (2015). Even some “mistakes” such as paying an annual fee may be rational as a means of limiting the risk of larger mistakes if future borrowing needs are uncertain. For a fuller discussion of the evidence that consumers make appropriate choices about credit cards, see Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki, *An Assessment of Behavioral Law and Economics Contentions and What We Know about Credit Card Use by Consumers*, 22 SUPREME COURT ECONOMIC REVIEW 1-54 (2014).

Sellers also have strong incentives to reveal negative information about products because less of a negative feature (e.g., lower fees) is a product benefit. Sellers who look better, therefore, have an incentive to say so. If consumers assume that sellers who are silent are inferior to those who talk about the attribute, there is an incentive for all but the worst product on that characteristic to disclose. This unfolding principle argues that sellers will voluntarily provide even negative product information, as long as competing offerings differ on the characteristic and the characteristic is important to consumers.<sup>37</sup>

Empirically, the evidence is clear that seller-provided information through advertising significantly enhances market performance in maximizing consumer welfare. Much of the evidence comes from studies of the effects of restrictions on advertising. The earliest restrictions studied were also quite broad, prohibiting advertising entirely in a particular market. One of the earliest studies examined the effect of state prohibitions on advertising of eyeglasses, and found that prices for eyeglasses were approximately 25 percent higher in states that adopted such restrictions.<sup>38</sup> Several subsequent studies confirmed this result in markets for optical goods and services.<sup>39</sup> Similarly, states that prohibited price advertising of prescription drugs had higher prices,<sup>40</sup> and the introduction of toy advertising to children led to lower toy prices.<sup>41</sup>

Blanket prohibitions on advertising ended when the U.S. Supreme Court extended First Amendment protection to commercial speech. Subsequent restrictions have been more subtle and more varied. Attorney advertising restrictions, for example, varied widely, with some states prohibiting broadcast advertising, some prohibiting pictures or illustrations, and some requiring that advertising be “dignified.” States with more restrictions had higher prices for routine legal services.<sup>42</sup> Restrictions on advertising media also raised product prices. The ban on broadcast advertising of cigarettes, for example, led to higher cigarette prices.<sup>43</sup> Similarly, when Quebec,

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<sup>37</sup> Sanford Grossman, *The Informational Role of Warranties and Private Disclosure about Product Quality*, 24 JOURNAL OF LAW & ECONOMICS 461-484 (1981). See also Paul Rubin, *The Economics of Regulating Deception*, 10 CATO JOURNAL 667-690 (1991).

<sup>38</sup> Lee Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15 J. L. & Econ. 337, 344 (1972).

<sup>39</sup> See, e.g., John E. Kwoka, Jr., *Advertising and the Price and Quality of Optometric Services*, 74 Am. Econ. R. 211, 216 (1984); Deborah Haas-Wilson, *The Effect of Commercial Practice Restrictions: The Case of Optometry*, 29 J. L. & Econ. 165, 182 (1986) (finding that “media advertising by optometrists is associated with lower prices”).

<sup>40</sup> John F. Cady, *Restricted Advertising and Competition: The Case of Retail Drugs* 11, 20 (1976).

<sup>41</sup> C. Robert Clark, *Advertising Restrictions and Competition in the Children’s Breakfast Cereal Industry*, 50 J. L. & Econ. 757, 759-60 (2007).

<sup>42</sup> John R. Schroeter, Scott L. Smith & Steven R. Cox, *Advertising and Competition in Routine Legal Service Markets: An Empirical Investigation*, 36 J. Indus. Econ. 49, 59 (1987).

<sup>43</sup> Robert F. Porter, *The Impact of Government Policy on the U.S. Cigarette Industry*, in *Empirical Approaches to Consumer Protection Economics* 447, 459 (Pauline M. Ippolito & David T. Scheffmann eds., 1986).

Canada, adopted restrictions on television advertising to children, the result was higher prices for children's cereals in Quebec compared with other parts of Canada; there was no increase in the price of adult cereals that could still advertise.<sup>44</sup>

The ability to advertise tends to lower product prices whether or not advertising actually includes price information. Price advertising has been found to reduce prices for retail gasoline,<sup>45</sup> prescription drugs, and retail liquor stores.<sup>46</sup> But advertising that rarely, if ever, includes price information has also been shown to lead to lower prices, as in the studies of toy advertising, cigarettes, and children's cereals discussed above. Knowing about more of the available alternatives facilitates consumer choice and encourages competition.

There is also evidence that the specific information content of advertising claims has significant market impacts. Again, the best evidence comes from studies of the effects of restrictions on advertising. Until the late 1980s, the Food and Drug Administration regarded any claim about the relationship between diet and disease as a drug claim and argued that any such claim made the product a misbranded new drug. In the 1960s, for example, the agency seized Quaker Oatmeal from store shelves because the label included a claim about the relationship between soluble oat fiber and serum cholesterol levels.<sup>47</sup> Some health claims appeared in food advertising, but they were relatively infrequent until claims were also permitted on food labels.

The regulatory environment began to change in 1984, when Kellogg launched an advertising and package label campaign for All-Bran promoting the National Cancer Institute's recommendation that diets high in fiber could reduce the risk of some forms of cancer.<sup>48</sup> Studies on the impact of the campaign found a significant market response. Fiber consumption increased, in part because of changes in purchasing patterns, but also because of changes in the products themselves. The weighted-average fiber content of breakfast cereals had been essentially constant for several years before the campaign began but increased significantly after 1984.

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<sup>44</sup> C. Robert Clark, *Advertising Restrictions and Competition in the Children's Breakfast Cereal Industry*, 50 J. L. & Econ. 757, 759-60 (2007).

<sup>45</sup> See Alex Maurizi & Thom Kelly, *Prices and Consumer Information: The Benefits from Posting Retail Gasoline Prices* (1978).

<sup>46</sup> Jeffrey Milyo & Joel Waldfogel, *The Effect of Price Advertising on Prices: Evidence in the Wake of 44 Liquormart*, 89 Am. Econ. Rev. 1081 (1999).

<sup>47</sup> See John E. Calfee & Janis K. Pappalardo, *Public Policy Issues in Health Claims for Foods*, 10 J. Pub. Pol'y & Mktg. 33, 36 (1991) (discussing the early history of regulation of health claims).

<sup>48</sup> FDA initially threatened enforcement action against Kellogg but backed down when the FTC and the NCI defended the claim. It suspended its prior policy prohibiting health claims, and in 1990, Congress codified the policy change. The regulatory history is detailed in J. Howard Beales III, Timothy J. Muris & Robert Pitofsky, *In Defense of the Pfizer Factors*, in *THE REGULATORY REVOLUTION AT THE FTC: A THIRTY-YEAR PERSPECTIVE ON COMPETITION AND CONSUMER PROTECTION* 83, 84, 90-91 (James Campbell Cooper ed., 2013).



There was no significant increase in the fat or sodium content of cereals.<sup>49</sup> Health claims about the relationship between saturated fat and heart disease also became far more common after the health-claim era began, and again there was a significant market impact. Fat and saturated fat consumption had both declined somewhat between 1977 and 1985, but both fell far more sharply after health claims became commonplace.<sup>50</sup>

An important finding from the health-claims studies is that advertising tended to have larger benefits in changing consumption for less educated and disadvantaged consumers than other consumers. In response to health claims about fiber, consumption increases were greatest among racial minorities and female-headed households.<sup>51</sup> The goal of advertising is to make information easily accessible, and that effect is more important for disadvantaged groups with less access to other information sources. Similarly, studies of restrictions on eyeglass advertising found that in states that restricted advertising, prices were highest for the least educated consumers.<sup>52</sup> Advertising that makes information more easily digestible is therefore particularly important to those who need information the most.

## 7.3 Markets for Information

Particularly in the internet era, consumers operate in deep and competitive markets for information. In an earlier age, finding disinterested articles or advice about a financial issue required either the coincidence of encountering a relevant article at an appropriate time in the decision-making process, or library research to extract useful material. Today, Google will offer up numerous answers to any question. Searches on nearly any financial question will, of course, yield sellers offering the product, but searches also yield links to objective information sources such as Investopedia and, often, advice from government agencies. The difficulty is not finding information; rather, the problem is choosing how much to search, which information links to pursue, and determining which information is reliable and worthy of attention. Information is readily available, but consumers must decide what information they wish to use.

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<sup>49</sup> Pauline M. Ippolito & Alan D. Mathios, Fed. Trade Comm'n, *Health Claims in Advertising and Labeling: A Study of the Cereal Market*, ix-xx (1989); Pauline M. Ippolito & Alan D. Mathios, *Information, Advertising and Health Choices: A Study of the Cereal Market*, 21 RAND J. Econ. 459, 473-74 (1990).

<sup>50</sup> Pauline M. Ippolito and Alan D. Mathios, *Information and Advertising: The Case of Fat Consumption in the United States*, 85 Am. Econ. Rev. 91, 92 (1995); Pauline M. Ippolito & Alan D. Mathios, FTC, *Information and Advertising Policy: A Study of Fat and Cholesterol Consumption in the United States, 1977-1990* 242 (1996).

<sup>51</sup> Ippolito and Mathios, *supra* note 24.

<sup>52</sup> Lee Benham & Alexandra Benham, *Regulating Through the Professions: A Perspective on Information Control*, 18 J.L. & ECON. 421, 444 (1975).

Increasingly, websites of information aggregators turn up early in the list of Google results. These sites assemble information from a wide variety of service providers, often allow easy sorting of product offerings by key features, and may offer to match consumers with a product that is “best” for them. For example, CreditCards.com organizes data about credit card offers from eight major issuers.<sup>53</sup> Consumers can see a list of card offers by feature (e.g., rewards card, zero percent APR, no annual fee) or browse a list of the “best” cards for a given credit-score range. They also have the option of supplying personal information to allow matching with a particular card that is thought to be appropriate for them or exploring the “best” cards either in general or in particular categories. The site offers “apply now” links that enable the consumer to apply for a product of interest directly.

NerdWallet offers similar options for credit cards, but it also includes a broader range of financial products, including various bank accounts; personal, student, and small-business loans; auto and life insurance; and investment services. Each product category includes financial education materials that offer advice about the category, and a more general “money” category provides information on budgeting, paying for college, moving, lowering utility bills, ways to make money, and a career guide.

Other information aggregators range far beyond financial services. Top10.com offers top 10 lists for financial service products, but it also offers lists for various services, including cocktail apps, crowdfunding platforms, and places to buy used textbooks. Similarly, ConsumerAdvocate.org<sup>54</sup> covers numerous financial products, including structured settlements, debt relief services, and cryptocurrency exchanges. The site also offers home and lifestyle product reviews (from mattresses and meal delivery services to kitchen remodeling and car shipping companies), and health product reviews (from blood tests to essential oils and online therapy).

The business models of the information aggregators vary. Some, such as Investopedia, are publishers, supported as publishers have always been by advertising revenue. Although advertising for specific products may be sold based on click throughs, there is little reason to suspect that the need for clicks would skew the editorial content, any more than the need for advertising revenue skews the editorial content of print publications. It is far more likely that the editorial content influences the kinds of products that are interested in advertising on such sites. This model seems to describe NerdWallet as well.

Probably the most common business model among information aggregator sites is receiving a commission or referral fee when consumers apply for or are accepted for a particular offering.

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<sup>53</sup> See <https://www.creditcards.com/?v1=true>

<sup>54</sup> See <https://www.consumersadvocate.org/>

For example, CreditCards.com is paid by financial service providers when consumers apply or are approved for an offer. This affiliate referral model is also employed by Top10.com and ConsumerAdvocate.org. NerdWallet also receives compensation through this model. All three aggregators disclose that they receive compensation, and that “this compensation may impact how and where products appear.”<sup>55</sup> Although some effect is certainly possible, when a site offers a wide range of products from numerous competing sellers, all of whom compensate the site, there is little reason to believe that financial incentives would significantly distort rankings or recommendations.

Some information aggregators offer comparative information as a complement to other services. Intuit’s Mint, for example, lets consumers sign up to view all their financial accounts in one place.<sup>56</sup> It also offers lists of various financial product offerings, including credit cards, personal loans, and certain insurance products. Companies pay to have their products included on the lists. LendingTree’s ValuePenguin includes similar lists.<sup>57</sup> Most personal loans listed are offers through the LendingTree website, but the site also offers credit cards, insurance products, and small-business products.

Consumers can also produce information themselves, through shopping competing sellers and comparing their offerings, either online or in person. For many products and services, consumers have prior experience, and perhaps the seller and can rely on what they learned both through the purchase process and through their experience using the product. That experience will enable them to identify, for example, the features of a particular credit card that they liked best, as well as pitfalls they may not have anticipated when the purchase was made initially. Subsequent decisions can take that learning into account.

An important source of information for many consumers is advice from family and friends, giving most consumers access to a broader base of experience. Marketers have long recognized the importance of this “word of mouth” information, and generally regard it as more influential than marketer-controlled information sources.<sup>58</sup>

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<sup>55</sup> The example is from creditcards.com’s “advertiser disclosure,” reached via a link on the home page. See <https://www.creditcards.com/>.

<sup>56</sup> See <https://www.mint.com/>

<sup>57</sup> See <https://www.valuepenguin.com/>.

<sup>58</sup> See Francis A. Buttle, *Word of mouth: understanding and managing referral marketing*, 6 JOURNAL OF STRATEGIC MARKETING 241-254 (1998).

Today, electronic word of mouth is an increasingly important influence on consumer behavior.<sup>59</sup> Third-party review sites such as Yelp are clear examples of electronic word-of-mouth communication, along with social media review pages and the Bureau's complaint database. Companies often seek to encourage such communication by offering opportunities to post reviews or to like or share content; doing so allows companies to see problems and address concerns that might otherwise circulate on social media without their knowledge. Firms also make investments in reputation management in an attempt to prevent bad consumer experiences from damaging a product or a reputation.

Consumers can also purchase advice from disinterested information sources such as Consumer Reports and comparable publications or from a wide variety of financial professionals, including real estate agents, accountants, and attorneys. Indeed, in many of the most complex financial transactions, other professionals are involved. A consumer searching for a new home is likely in contact with a real estate broker who is likely familiar with the pros and cons of various financing options.<sup>60</sup> The broker's primary incentive is to find a deal that will make the consumer happy, generating both a commission and the prospect of future referrals that make the broker happy.

Information has a cost, in time, attention, and effort to use it. No consumer will pursue all available information, because the cost of doing so would far exceed the benefits. There is no evidence that too little information is available, but consumers must choose which information to pursue – with or without disclosure.

## 7.4 Consumer Behavior and Information Processing

If information is to have an impact, at least some consumers must use it. We are all bombarded with thousands of stimuli every day, and we cannot possibly pay careful attention to each one. The marketing literature on information processing, derived from cognitive psychology, examines in detail the road from an information stimulus to the use of that information.

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<sup>59</sup> Ismagilova, E., Slade, E.L., Rana, N.P. et al. The Effect of Electronic Word of Mouth Communications on Intention to Buy: A Meta-Analysis. *INF SYST FRONT* (2019).

<sup>60</sup> The National Association of Realtors 2019 Profile of Home Buyers and Sellers found that 89 percent of buyers purchased their home through a real estate agent or broker; 5 percent purchased directly from a builder or the builder's agent. Ninety percent of buyers would use their agent again. Available at <https://www.nar.realtor/research-and-statistics/research-reports/highlights-from-the-profile-of-home-buyers-and-sellers#searchprocess>.

Consumers must be exposed to information, pay attention to it, comprehend it, accept it, and retain it.<sup>61</sup>

The first step in the process is exposure. Whether it is marketing information, required disclosures, or some other information, it must be presented to the consumer in a way that consumers can perceive it. Exposure may fail if information is directed to the wrong audience or it becomes available at the wrong time.<sup>62</sup>

A consumer exposed to information then must pay attention to it. Attention may be more likely if the information is seen as having immediate utility, as it might be if it pertains to a purchase or transaction that a consumer is contemplating when exposure occurs. Timing therefore matters; a consumer considering whether to purchase a sedan or an SUV is less likely to attend to information about financing than one who has settled on a vehicle and is seeking the best deal. The message itself also influences the likelihood that consumers pay attention. Many advertising techniques, from catchy jingles to splashy graphics, are devices that seek to attract the consumer's attention.<sup>63</sup>

After exposure and attention, a consumer must comprehend the message. Unfortunately, any message can simply be misunderstood.<sup>64</sup> Comprehension depends in part on the degree of attention to the message; a message that is only partially attended to is less likely to be understood correctly. Comprehension also depends on the clarity and complexity of the information, with a more ambiguous or complicated message less likely to be fully understood. Moreover, comprehension of any message is likely to vary from one consumer to another, if for no other reason than the different backgrounds and experiences of different individuals.

Once comprehended, a message must be accepted. A message may be correctly understood but rejected on the basis of prior experience or a counterargument that strikes the consumer as more persuasive. A message that consumers reject will have little influence on behavior.<sup>65</sup>

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<sup>61</sup> For a fuller discussion of the information processing literature, see DURKIN AND ELLIEHAUSEN, *supra* note 12, at 53-55. An alternative formulation of the sequence of using information is that consumers must find it, read it, understand it, use it, use it appropriately. See OMRI BEN-SHAHAR AND CARL E. SCHNEIDER, MORE THAN YOU EVER WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE, 34 (2014).

<sup>62</sup> See William L. Wilkie, *Affirmative Disclosure at the FTC: Communication Decisions*, 6 JOURNAL OF PUBLIC POLICY & MARKETING 33 (1987).

<sup>63</sup> See e.g. Steven Bellman, Magda Nenycz-Thiel, Rachel Kennedy, Nicole Hartnett, and Duane Varan, Best Measures of Attention To Creative Tactics in TV Advertising, 59 Journal of Advertising Research Sep 295-311 (2019).

<sup>64</sup> See the discussion of misunderstanding in Section E 1 below.

<sup>65</sup> See e.g., Julie A. Edell and Kevin Lane Keller. "The Information Processing of Coordinated Media Campaigns." 26 Journal of Marketing Research 149-63 (1989).

Finally, the information must be retained in memory until it is needed. Although long-term memory capacity is nearly limitless, short-term or immediate memory is much more limited. People can retain and process only about seven “chunks” of information at a time.<sup>66</sup> Too much information all at once can easily overwhelm these limits.

An implication of the information-processing approach is that the timing of the provision of information may be critical. Timing affects the likelihood of exposure and attention. Information provided at the time it is wanted reduces the need to store the information in memory for later retrieval; the information can be used at the time it is received. Information provided after a transaction is concluded obviously did not influence the purchase decision, although it may influence evaluation of the transaction and thereby affect future decisions.

The importance of timing has led to interest in “just in time” disclosure. Such a disclosure is one that arrives precisely when the information is needed. A clear example is the low-balance alert that tells consumers both that their account balance is low and that, if they overdraw, they will incur certain fees. Such a disclosure is likely to be far more effective than a generic statement about overdraft fees that is repeated on every periodic statement. On the statement, the information is not timely—consumers must remember it and remember to check their balance regularly. A “just in time” low-balance warning solves both problems.

Although just-in-time disclosure is an important aspirational goal, it is not clear how it could be implemented in regulatory requirements. Much of the information in financial disclosures may be relevant to different consumers at different times. In shopping for a new car, for example, some consumers may first consider the cost of financing at different financial institutions and would find information about the APR useful and relevant. Other consumers may shop for the car first and would be more interested in information about the car and its features. Those consumers might then use the dealer’s financing offer as a baseline for comparison. What constitutes “just in time” is not clear in such circumstances.

The potential value of just-in-time information to consumers implies that policymakers should avoid unnecessary burdens on such disclosures. In particular, it is easy to imagine information beyond the fee and the balance that could be relevant in the case of the low-balance alert (e.g., when and how much is the next regularly scheduled automatic deposit), but a requirement for more fulsome disclosure could prevent the service from getting off the ground in the first place.

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<sup>66</sup> See George A. Miller, *The Magical Number Seven, Plus or Minus Two: Some Limits on Our Capacity for Processing Information*, 63 PSYCHOLOGICAL REVIEW 87-97 (1956). This is one of the most widely cited articles in the psychology literature.

As discussed more fully below, before the Truth in Lending Simplification and Reform Act, required disclosures led sellers to abandon advertising of interest rates.

## 7.5 Disclosure and its Limitations

The solution to problems that may result from incomplete information seems so obvious: Just disclose the needed information to consumers. That has been the widespread policy response whenever there is a realization that some additional fact would have been useful to at least some consumers on at least some occasions. The result has been an unchecked proliferation of mandatory disclosures. Truth in Lending has grown from an original proposal to disclose an effective interest rate and finance charges to a detailed list of 20 items for closed-ended credit in one listing, plus additional.<sup>67</sup> One author described a mortgage-closing package with 49 disclosures spread over 101 pages.<sup>68</sup> Open-end consumer credit requires 31 itemized disclosures.<sup>69</sup> Similarly, the California Retail Installment Sale agreement has grown from an 8x11-inch single page with four disclosures, 743 words, and two signature lines in 1961 to a document known colloquially as the bedsheet, with 16 disclosure boxes, 2,051 words, and eight.<sup>70</sup>

Extensive disclosure of all potentially relevant details does not solve the problem of how much to invest in acquiring information. It addresses, at best, only exposure, the first step in the information processing that is necessary if a consumer is going to use the information. Instead, extensive disclosure simply transforms the problem of finding information into one of how to allocate attention to the abundance of details. It seems safe to say that no one decides about refinancing a house by carefully evaluating all 49 disclosures, and no one chooses a credit card based on carefully weighing the 31 items that must be disclosed. Attention is scarce, and there are far more attractive things to pay attention to. “Even experts helping people invest for retirement used an average of just six of the many variables.”<sup>71</sup>

Again, differences in the types of information sought by different consumers are significant. For example, nearly two-thirds of credit card users who almost always pay their balance in full and opened a new account found the account opening disclosures not very or not at all useful. In

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<sup>67</sup> DURKIN AND ELLIEHAUSEN (2011), *supra* note 12, p. 234-235.

<sup>68</sup> BEN-SHAHAR AND SCHNEIDER (2014), *supra* note 61, p. 22.

<sup>69</sup> DURKIN AND ELLIEHAUSEN, *supra* note 12, at 236.

<sup>70</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 24-25.

<sup>71</sup> *Id.* at 102.

contrast, among those who carry a balance, 85 percent thought the information was very or somewhat useful.<sup>72</sup>

Despite its attractions, disclosure has important limitations as a solution to information problems. Like any other communication, disclosures may be misunderstood. Disclosing too much information can result in information overload, leading consumers to ignore information and be less informed, not better informed. Disclosures also displace other information that may be more valuable. And compliance is complex and costly.

## 7.5.1 Disclosures May be Misunderstood

Any communication can be misunderstood. That commonplace fact of daily life applies with equal or greater force to marketing communications and the required disclosures that seek to provide additional information. If enough recipients are exposed to a message and pay attention to its content, some of them will misunderstand, in a manner that may be completely wrong and may be very different than what was intended. Academic studies of brief communications have examined misunderstanding of both advertising and editorial content of print and video communications, and found that 20 percent to 30 percent of the audience misunderstands some aspect of the communication. Although advertisers devote considerable resources to determining how best to convey their message, the level of misunderstanding was not significantly different for advertising and editorial content.<sup>73</sup>

One source of misunderstanding is the inherent ambiguity in language, particularly qualitative language. The same word may mean different things to different people. In a study of business communications with college students, subjects were asked to assign a numerical probability to generic probability terms. “Always” was interpreted, on average, as occurring around 90 percent of the time but with a standard deviation of around 15 percent. “Never” was interpreted as 8 percent to 14 percent in three different groups, with standard deviations of 15 percent to 25 percent.<sup>74</sup> In a study in a medical context, only 80 percent of patients agreed that “certain” meant 100 of 100 people; only 67 percent agreed that “never” meant 0 of 100 patients. Patients

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<sup>72</sup> Canner and Elliehausen, *supra* note 17, at 28.

<sup>73</sup> See Jacob Jacoby et al., *Miscomprehension of Televised Communications* 64 (1980) (noting the statistics of miscomprehension for television viewers). For print communications, see Jacob Jacoby & Wayne D. Hoyer, *The Comprehension and Miscomprehension of Print Communications* (1987).

<sup>74</sup> Edward C. Brewer and Terence L. Holmes, *Obfuscating the Obvious: Miscommunication in the Interpretation of Common Terms*, 46 J. BUSINESS COMMUNICATION 480-496 (2009). Results are presented in Table 2, p. 490.



assigned numerical probabilities to complications described as “unlikely” that were three times higher if the complication was minor than if the complication was a major one.<sup>75</sup>

In the business communications study, “probably,” “usually,” and “often” were all assigned about the same numerical probability, generally around 60 percent, with a standard deviation of about 15 percent. To take a specific example, the mean probability of “probably” was 61 percent. A person who interprets the word in a way that is one standard deviation above the will be describing a probability of 78 percent. If the recipient assigns a meaning that is one standard deviation below the mean, the recipient will *understand* a probability of 44 percent.<sup>76</sup> Studies have also found that recipients assign higher numerical probabilities to chance terms if the chance is for something that is good for them personally than if it is good for others; they assign a lower probability if the risk is an unpleasant event for them than when the risk applies to others.<sup>77</sup> “One study found doctors’ interpretations of ‘likely’ ranging ‘from 25 to 75 percent,’ and another study found interpretations of ‘very likely’ ranging ‘from 30 to 90 percent.’ ”<sup>78</sup>

Time words are similarly ambiguous. In the business communications study, the one standard deviation range of hours meant for a request to be completed “ASAP” was from 27 to 72 hours. “Right away” seems to convey more immediacy, with average times of four to nine hours, but the standard deviations are huge, 15-20 hours.<sup>79</sup>

An additional problem for consumer comprehension is that different disclosures may define certain terms differently. Different regulations include “days,” “business days,” and “calendar days” that differ in how they count weekends and holidays (and which holidays matter). Even when regulations use the same term, such as “business day,” they may have different definitions. Regulation Z even has different definitions of a business day depending on which section of the regulation is at issue.<sup>80</sup> If a business day has a different definition in different disclosures, consumer misunderstanding of one or the other is nearly inevitable.

Given the inherent difficulties of communication, it should not be surprising that disclosures are often not fully understood. When consumers misunderstand the disclosure or its significance,

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<sup>75</sup> Kimberly Koons Woloshin, Mack T. Ruffin, and Daniel W. Gorenflo, *Patients’ Interpretation of Qualitative Probability Statements*, 3 ARCH. FAM. MED 961-966 (1994).

<sup>76</sup> Brewer and Holmes, *supra* note 74, Table 2.

<sup>77</sup> Tim Smits and Vera Hoorens, *How Probable is Probably? It Depends on Whom You’re Talking About*, 18 J. BEHAV. DEC. MAKING 83-96 (2005).

<sup>78</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 160.

<sup>79</sup> Brewer and Holmes, *supra* note 74, Table 2.

<sup>80</sup> See 12 C.F.R. 1062.2(a).

the result may be worse decisions, not better ones. Examples of such disclosures are numerous. A study of college students' perceptions tested comprehension of three credit card disclosures, scoring one point for each disclosure that was correctly understood. Across a variety of conditions, the highest value for the sample average total score was 1.71, implying that the average college student did not comprehend slightly more than one of the three disclosures.<sup>81</sup> Similarly, an experimental study of mutual fund cost disclosures concluded that "cost information supplied in the ads appears to be either ignored or misunderstood."<sup>82</sup>

Incomplete understanding of disclosures can lead to worse decisions, not better ones. The Federal Trade Commission tested improved disclosures under the Real Estate Settlement Procedures Act (RESPA) that included information about the yield spread premium. The study asked consumers to compare the disclosures for two different mortgages and choose the lowest-cost offer. When the loans had different costs, consumers were significantly less likely to choose the low-cost mortgage. When the loans had the same cost, participants who received the yield spread premium disclosure were less likely to recognize that the cost was the same. Moreover, most participants believed that broker loans, which included the disclosure, were more expensive than direct loans from the lender, where there was no disclosure, even when the total cost of the loans was the same.<sup>83</sup> Clearly, more information did not lead to better decisions.

Comprehension testing of disclosures can help to assure that consumers understand the message. In the TILA-RESPA Integrated Disclosure (TRID) rulemaking, the Bureau did extensive work to improve the layout and wording of disclosures to enhance comprehension. But understanding is not enough. Consumers must use the disclosures to make a decision, and even if they understand each item individually, and as discussed in the next section, more information may degrade choices rather than enhance them. Better decisions, such as correctly identifying the lowest-cost mortgage, tested in a context where the answer is clear, are the ultimate evidence of whether disclosures work.

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<sup>81</sup> Veronica Thomas, Kendra Fowler, Richard H. Kolbe, The Implications of the FTC's Clear and Conspicuous Standards for the Communication of Credit Card Information to Young Consumers, 16 JOURNAL OF FINANCIAL SERVICES MARKETING 195 (2011), at Table 6.

<sup>82</sup> Beth A. Pontari, Andrea J. S. Stanaland, Tom Smythe, Regulating Information Disclosure in Mutual Fund Advertising in the United States: Will Consumers Utilize Cost Information?, 32 J. CONSUM. POLICY 333 (2009).

<sup>83</sup> James M. Lacko and Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, BUREAU OF ECONOMICS STAFF REPORT (2004), available at <https://www.ftc.gov/sites/default/files/documents/reports/effect-mortgage-broker-compensation-disclosures-consumers-and-competition-controlled-experiment/030123mortgagefullrpt.pdf>.

## 7.5.2 Too Many Disclosures Result in Information Overload

As described above, extensive disclosures accompany even relatively simple decision tasks such as choosing a credit card provider. One of the premises of these disclosures is that more information will enhance consumer decisions about which product or provider to choose. The extensive academic literature on information overload argues that more information does improve decisions, but only up to a point. “If further information is provided beyond this point, the performance of the individual will rapidly decline.”<sup>84</sup> Additional information will not be integrated into the decision. Instead, it will confuse recipients, distort their ability to set priorities, and make it more difficult to recall other relevant information that should be considered. The result is stress, and a poorer quality decision.<sup>85</sup> Rather than reducing the costs of information, and thereby increasing information use, excessive disclosures may actually reduce information use and result in worse consumer decisions.

Information overload results from a mismatch between information-processing requirements and information-processing capacity. Processing requirements focus on the amount of information that *must* be integrated in order to make a decision. Processing capacity refers to the amount of information that a recipient *can* integrate in a given amount of time. When processing requirements exceed capacity, the result is information overload.<sup>86</sup>

One way to think about information overload is from the perspective of information costs.<sup>87</sup> Adding more information will increase the cost of using that information because consumers must read and understand the entire message to find the items in which they are interested. If consumers decide that the information is not worth the effort, they may simply ignore the message. Offered an encyclopedia to answer a simple question, consumers may simply decide that the answer is not that important after all. The result may be more information in a disclosure but less information actually received and understood by the consumer. As discussed above, a seller’s market incentive is to provide easily usable information that is relevant to most consumers; the regulator’s incentive is to provide any information that some might find useful.<sup>88</sup>

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<sup>84</sup> Martin J. Eppler & Jeanne Mengis The Concept of Information Overload: A Review of Literature from Organization Science, Accounting, Marketing, MIS, and Related Disciplines, 20 THE INFORMATION SOCIETY 325-344, 326 (2004)

<sup>85</sup> Eppler & Mengis (2004), *supra* note 84.

<sup>86</sup> Eppler & Mengis (2004), *supra* note 84.

<sup>87</sup> See Joseph P. Mulholland, Summary Report on the FTC Behavioral Economics Conference (2007) *available at* <https://www.ftc.gov/sites/default/files/documents/reports/summary-report-ftc-behavioral-economics-conference/070914mulhollandrpt.pdf>.

<sup>88</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at Chapter 6, The Politics of Disclosure.

For purposes of considering disclosures, one relevant cause of information overload is the information itself. Information-processing capacity is higher, and information overload less likely, when information is concise, consistent, and comprehensible. In contrast, information that is uncertain, ambiguous, or complex is more difficult to process.<sup>89</sup>

The person and the task also affect the likelihood of information overload. Consumers differ in their innate ability to process information to some extent. Learned skills and experience in dealing with a particular type of information also reduce the risk of information overload; a skilled financial practitioner is far less likely to be overwhelmed than a consumer facing a complex financial decision for the first time. Individual motivation to understand and use the information also matters. Routine tasks and less complex tasks reduce information load, and the likelihood of overload.<sup>90</sup>

Different information cues effectively compete. The more salient ones tend to undermine the less salient ones. Adding irrelevant cues can mislead consumers to ignore or misunderstand relevant ones.<sup>91</sup> That was certainly the result in the study of yield spread premium disclosure discussed above. Consumers receiving disclosures containing the yield spread premium were less likely to identify less expensive loans than consumers who received otherwise identical disclosures without the yield spread premium. Identifying, understanding, and remembering relevant information is itself a difficult task, but reasoning with that information is an even more challenging cognitive process.<sup>92</sup>

There can be little doubt that current disclosure requirements often result in information overload. The California bedsheet, the lengthy list of Truth in Lending disclosures, and the mortgage settlement package described at the beginning of this section far exceed any plausible estimate of information processing capacity. Rather than informing, they may serve primarily to make a financial decision that many consumers would find intimidating in the first place even more opaque and forbidding.

Faced with information overload, consumers have a number of common reactions. Recipients tend to become highly selective about what information they consider, ignoring large amounts of information. They have increased difficulty relating details to the overall picture and the overall decision. They need more time to decide—and they make worse decisions. As one review noted,

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<sup>89</sup> Eppler & Mengis (2004), *supra* note 84, at 331.

<sup>90</sup> Eppler & Mengis (2004), *supra* note 84, at 331.

<sup>91</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 101.

<sup>92</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 103.

“...there is wide consensus today that heavy information load can affect the performance of an individual negatively (whether measured in terms of accuracy or speed).”<sup>93</sup>

Regulatory requirements should constantly consider the risks of information overload. If the goal is better consumer decisions, too much disclosure may make matters worse. Information should be provided in a convenient format, but better formatting is not enough. Most important, information that is delivered should be high value, with a clear relationship to the decision that the consumer confronts.<sup>94</sup> Instead, we have disclosures that fail as literary works that motivate consumers to read. “Graceless sentences, dubious grammar, and vulgar syntax rule. The story is plotless, lifeless, humorless, endless.”<sup>95</sup> The standard of providing high-value information clearly relevant to the decision at hand is surely not met by many, if not most, of the long list of items that must be disclosed under Truth in Lending requirements, let alone in privacy policies.

Behavioral economists have identified a somewhat similar phenomenon as choice overload. Backed by some experimental evidence, they argue that, faced with “too many” choices, consumers may decide not to choose at all. In effect, too many options can be paralyzing. So why aren’t Walmart superstores, which offer more than 150,000 choices, filled with paralyzed shoppers unable to make decisions? It is because Walmart and other retailers have strong market incentives to organize the options to facilitate decision making, effectively highlighting the more relevant alternatives.<sup>96</sup>

As discussed above in the section on seller-provided information, sellers have incentives to do the same with information: to provide the information that consumers consider relevant in a readily digestible fashion. Disclosures required for a new checking account are elaborate and complex, but many banks, covering half of U.S. deposits, have adopted a disclosure summary to make the information-processing task more manageable. Unfortunately, the summary itself is another form on the pile because the required disclosures must still be provided.<sup>97</sup> Moreover, providing a summary runs the risk of being accused of trying to obscure the required disclosures, rather than emphasizing them. Information aggregators are also striving to provide consumers with relevant, digestible information. Regulatory requirements to provide information that may

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<sup>93</sup> Eppler & Mengis (2004), *supra* note 84, at 331.

<sup>94</sup> Eppler & Mengis (2004), *supra* note 84, at 334.

<sup>95</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 77.

<sup>96</sup> See the discussion in J. Howard Beales III, *Behavioral Economics and Credit Regulation*, 11 J.L. Econ. & Pol’y 349 (2015).

<sup>97</sup> Novantas Research, *Understanding Consumer Choice: A Review of Consumer Overdraft Behaviors* (2015), at 18.

be of little relevance to most consumers undermine these attempts to make complexity more manageable.

Mandatory disclosures provide uniform information for heterogeneous products to heterogeneous consumers. The most useful information, however, may vary with the nature of the transaction. For example, APR and finance charge are not very useful in mortgage transactions, where the contract interest rate and closing costs are the key variables, but dollar finance charge information may be the most useful information in considering short-term, small-dollar loans. The APR for short-term and small-dollar loans may even be misleading.<sup>98</sup>

As discussed above, consumers often use financial products differently, and are therefore interested in different product features. Many consumers pay off their credit card balances in full every month, and therefore have little interest in details about the APR. Nevertheless, the first lines of information in the Schumer box provide the APR, the balance transfer APR, the cash advance APR, and any other APRs that may apply in other circumstances. Even that information may not apply if, as is often the case in application disclosures, the rate depends on the creditworthiness of the customer. Other consumers are interested in the rewards that they might receive for using the card, and the Schumer box tells them nothing of interest. Instead, it provides information about other fees that may be relevant eventually, such as late fees, as well as fees such as foreign currency conversions and foreign transaction fees that may never be relevant for most consumers. Moreover, it seems likely that exceedingly few decisions, if any, about which card to apply for are driven by differences in any of these fees. Markets tailor information to the audience most likely to find that information of interest; uniform required disclosures cannot do so.

Consumers likely differ in the information they seek about other credit products as well. In searching for an auto loan, a credit-constrained consumer may be most interested in the monthly payment and the required down payment. A consumer who can borrow as much as desired is more likely to care about minimizing the total cost of credit over the expected life of the loan.

Too much information is also the inevitable consequence of the fact that disclosure requirements are almost never removed. There may have been a time when the minimum finance charge was an important differentiator between competing card products, but that is hardly the case today. Nonetheless, the minimum finance charge remains a prominent part of

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<sup>98</sup> See WALLACE P. MORS, CONSUMER CREDIT FINANCE CHARGES: RATE INFORMATION AND QUOTATION (1965). For example, a payday loan for \$100 that costs \$15 will only cost \$15 if it is repaid on time, not the \$300 that an APR of 300% might suggest.

the Schumer box. It is difficult to imagine that the total of payments was ever useful information on a 30-year mortgage, but there it is in the Truth in Lending disclosures. It likely does not have much utility for an auto loan either, but again, it is part of the required disclosures. Some states require disclosure that married women can ask to have their credit reported in their own name. That information may have been vital at one time, but the disclosure is clearly an anachronism when credit reports are routinely compiled on individuals, not households. The problem is gone, but the disclosure is not. Similarly, there is serious doubt about the continued utility of the required disclosure on any application asking for “income” that the applicant need not disclose income from alimony, child support, or separate maintenance payments if they do not want that income considered.<sup>99</sup> And surely, as automated teller machines evolved, the statutory requirement for a physical placard disclosing out-of-network fees was obsolete long before Congress repealed the requirement in 2012.

Obsolete disclosures highlight an important tension in disclosure requirements between specific regulatory requirements and more flexible, principles-based approaches to what must be disclosed. Regulated entities often value certainty: They simply want to know what they must do to comply, and precisely how to do it. Consumer advocates often fear that required disclosures might be hidden, or lack sufficient prominence to gain the consumer’s attention. Both desires often lead to detailed, prescriptive requirements, including in many instances specific requirements for font size and particular formatting, such as disclosures in ALL CAPS or in **boldface type**. Without careful testing, formatting requirements may actually make things worse. An experimental study of contract disclosures that were in all caps found that older subjects were significantly less likely to understand the disclosures than those who read the same disclosure in normal text.<sup>100</sup> Unfortunately, such requirements are very difficult to change, particularly when they are written into statutes. Moreover, font requirements written with the printed page in mind may make little sense when translated to a smartphone.

Marketers routinely change their communications because of the well-known phenomenon of wear-out—if the same message is repeated the same way over and over again, consumers will learn to tune it out. If legislators must specify disclosure details, they should leave regulators the flexibility to determine that a particular disclosure or particular formatting requirement is no longer necessary or appropriate. And regulators should periodically examine the mass of required disclosures with a sharp eye toward eliminating those that contribute more to information overload than they add to consumer enlightenment.

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<sup>99</sup> 12 C.F.R. 1002.5 (d) (2).

<sup>100</sup> YONATHAN A. ARBEL AND ANDREW TOLER, ALL-CAPS, SSRN 3519630 (2020).

If disclosures are providing useful information, they will favor some firms over others because they look better on the disclosed attribute. Firms with an advantage have every incentive to develop better ways to convey that information to consumers, and therefore to devise disclosures that may do exactly that. Moreover, even if a particular disclosure regime is perfect in every detail at the time it is adopted, changes in products and in markets as new products emerge will likely also change the best way to disclose the information. Changes may make some disclosures irrelevant or may create the need to revise disclosures to avoid conveying a misleading impression to consumers as they consider a new product using disclosures designed with a different product in mind.

In this regard, the Bureau's recent decision to establish a trial disclosure sandbox is a step in the right direction. The sandbox allows firms to apply for a waiver to test possible improvements in disclosure content, format, or delivery.<sup>101</sup> Provided the participation conditions are not unreasonably burdensome, the sandbox offers a real opportunity to build a more flexible disclosure regime better attuned to consumers' needs. Not all experiments will succeed, but the monitoring requirements that are part of the sandbox should provide clear evidence if there is a need to change course.

### 7.5.3 Displaced Information

Many disclosures, such as those accompanying a mortgage, are delivered to the consumer in separate documents. There are, of course, costs of printing and distributing such disclosures, along with the costs of determining what must be disclosed. And, as discussed in the previous section, disclosures may distract consumers from other information that is more important to them, resulting in worse decisions than would otherwise occur. Disclosures add to the information confronting the consumer, however, and do not directly displace anything.

Other disclosures, however, displace information that would otherwise be available to the consumer. This phenomenon is most obvious with advertising disclosures, where time and space devoted to the disclosure cannot be used for other purposes. In purely monetary terms, these costs can be substantial. In 2018, the average price of a 30-second prime-time television advertisement on the top four national networks was \$127,000, implying that disclosures cost more than \$4,000 per second.<sup>102</sup> In print advertising, even blank space has value, because it

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<sup>101</sup> Links to the policy and the application can be found at <https://www.consumerfinance.gov/policy-compliance/innovation/trial-disclosure-program/>.

<sup>102</sup> Calculated from price data in Jeanine Poggi, Here's How Much it Costs to Advertise in TV's Biggest Shows, AdAge (October 2, 2018), available at <https://adage.com/article/media/tv-pricing-chart/315120>. The rationale for estimating disclosure costs based on the time or space consumed is explored more fully in Beales, Craswell, and Salop, *The Efficient Regulation of Consumer Information*, 24 JOURNAL OF LAW AND ECONOMICS 491 (1981).



helps to set off the relevant portions of the message and enhance attention and readability. Cluttering advertisements with required disclosures should be avoided unless the added information is truly important to an informed choice for most consumers.

For consumers, too many disclosures produce information overload, effectively leading to consumers who are less informed. For sellers, excessive requirements produce information avoidance—sellers choose to talk about product characteristics that are less burdened with required disclosures. That was exactly the effect of the original advertising disclosure requirements in the Truth in Lending Act: “Upon the advent of Truth in Lending, for instance, most creditors simply stopped advertising interest rates.”<sup>103</sup> The reduced disclosure requirements that resulted from the 1980 Truth in Lending Simplification Act made present-day credit advertising feasible.

Requiring too much information can effectively prohibit advertising because there is no feasible way to satisfy the requirements. For many years, that was the case with direct-to-consumer advertising of prescription drugs on television. The requirement to provide a “brief summary” of prescribing information could be satisfied in print advertising by purchasing roughly an extra page of space, but it could not be met in television advertising.<sup>104</sup>

Less dramatic disclosure requirements can also steer advertising in different directions, as the experience with health claims for foods clearly demonstrates. When the Food and Drug Administration (FDA) first approved specific health claims for foods (effective in 1993), the rules included detailed information about the particular diet-health relationship, along with “model claims” written by FDA that provided detailed information, such as who was most at risk for the particular disease and what other risk factors were relevant. Many advertisers apparently believed that an advertisement must include all this information. The result was a sharp decline in the incidence of health claims, from 11 percent of all magazine food advertising in 1989 to less than 3 percent in 1992-1994. Claims about heart disease and serum cholesterol fell from 8.2 percent of all advertising in 1989 to zero in 1994. When the FDA clarified in 1995 that advertisers need not use the model claims as long as claims were not misleading, health claims

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<sup>103</sup> Gerald J. Thain, *Credit Advertising and the Law: Truth in Lending and Related Matters*, 1976 WASH. U. L. Q 257, 275 (1976).

<sup>104</sup> See Margaret Gilhooley, *Heal the Damage: Prescription Drug Consumer Advertisements and Relative Choices*, 38 J. Health L. 1, 17-18 (2005). Rather than revise the rules, the FDA issued a Guidance Document that allowed broadcast advertising without including the brief summary. See *Guidance for Industry on Consumer-Directed Broadcast Advertisements*, 64 Fed. Reg. 43,197, 43,197-98 (Aug. 9, 1999).

rebounded, reaching 8 percent of ads by 1997; serum cholesterol claims rebounded to 4 percent.<sup>105</sup>

Current disclosure requirements for financial services advertising do not appear nearly as burdensome as the short-lived “model claims” regime for health claims, although, as noted above, the requirements in the original statute led to substantial reductions in interest rate advertising. The utility of current disclosures, however, is highly questionable. It is difficult to imagine that very many consumers can read the fine-print television disclosures of the other terms of a “0% APR, offer, that they remember any of those details, or that those details, pertaining to a hypothetical consumer who may be “well qualified” or “approved” in a hypothetical transaction are in any way useful in making a decision. These are disclosures that may satisfy regulatory requirements, but they do little to assist consumers.

Of course, consumers need to understand the basic terms of the transaction before it is consummated. Advertising, however, offers options for consideration, not the fully specified details of a purchase or lease for a complex product and a complex transaction. “Click for details” seems like exactly the right way to make such information available in online advertising,<sup>106</sup> because consumers can access the information when they move from considering options to considering a specific offer. Attempting to provide all such details in conventional media advertising, however, serves no useful purpose.

## 7.5.4 Compliance

From the regulator’s perspective, disclosures are often a relatively cheap solution. Other than writing and enforcing the rules, they cost the government nothing.<sup>107</sup> Compliance, however, is a different matter. Microsoft Word counts more than 380,000 words of “complicated legalese”<sup>108</sup> in the 2013 version of Regulation Z. Simply reading the rules is itself a major undertaking, let

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<sup>105</sup> See Pauline Ippolito & Janis Pappalardo, Advertising Nutrition & Health: Evidence from Food Advertising 1977-1997 E-8 to -11 (2002) (providing detailed data on the incidence of various health claims).

<sup>106</sup> Regulators are often concerned that “too few” consumers will actually click for details. But consumers do click when they are interested. Even low click-through rates do not mean that consumers are not getting the information they need. Search advertising is highly profitable for advertisers, for example, but the click-through rate over the year ending in the first quarter of 2020 was a maximum of 2.88 percent. And only 1.55 percent in the first quarter of 2020. Display advertising click-through rates are substantially lower. See <https://www.smartinsights.com/internet-advertising/internet-advertising-analytics/display-advertising-clickthrough-rates/>. Moreover, consumers may make several visits to a website before making a decision. One source reports that the lag between first click and conversion averages 3.5 days. See <https://neilpatel.com/blog/what-is-the-optimum-number-of-clicks-before-conversions-start-happening/>.

<sup>107</sup> BEN-SHAHAR AND SCHNEIDER, *supra* note 61, at 145.

<sup>108</sup> DURKIN AND ELLIEHAUSEN, *supra* note 12, at p. 9.

alone understanding their implications, the obligations they impose, how they might affect various products that a financial institution offers, and the details of what compliance requires.

These are essentially fixed costs, largely independent of the size of the organization, and they create a cost disadvantage for smaller institutions, which must spread the costs over a smaller base. The fact that costs per account or other measure of output are higher for smaller institutions is well documented in the literature. Studies of initial compliance costs with the Equal Credit Opportunity Act (ECOA), the Electronic Fund Transfer (EFT) Act, and the Truth in Savings Act all find evidence of higher average costs for smaller financial institutions. Average costs of ongoing compliance have also been found to be higher for the EFT Act, Truth in Lending, the ECOA, the Community Reinvestment Act, the Bank Secrecy Act, and the Real Estate Settlement Procedures Act.<sup>109</sup> A more recent study of all compliance costs at community banks (assets under \$10 billion) using survey data from 2015-2017 found that compliance costs were 9.8 percent of total noninterest expenses for the smallest institutions (less than \$100 million in assets), declining to 5.3 percent for the largest category examined (\$1 billion to \$10 billion in assets).<sup>110</sup> The survey attributed 21.2 percent of compliance costs to TILA, RESPA, and Regulation Z; 12 percent to deposit account compliance; 8 percent to the Qualified Mortgage rules; and 6.7 percent to Ability to Repay rules.<sup>111</sup>

Much of the complexity of Truth in Lending regulation stems from two fundamental conceptual problems that are inherent in the disclosure scheme. The first is what has been termed the outlay issue<sup>112</sup>—which costs of concluding a transaction are part of the cost of credit, and which are costs attributable to other aspects of the purchase? In some instances, the separation is straightforward. It is easy to say, for example, the voluntary credit insurance purchased at the time of the transaction is a separate purchase and not part of the cost of credit. Fundamentally, however, credit is often part of a joint purchase—purchase of a car, a house, or consumer goods—paid for over time. Like any other joint production problem, the allocation of many of the costs of the combined purchase to one component or the other is fundamentally arbitrary. The problem is perhaps clearest in purchasing a car. What matters to the consumer is the total cost of the car and the credit, but shifting costs between “credit” costs and “automobile” costs is

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<sup>109</sup> The relevant studies are reviewed and reported in Greg Elliehausen, *The Cost of Bank Regulation: A Review of the Evidence*, FEDERAL RESERVE BOARD, STAFF STUDY No. 171 (1998).

<sup>110</sup> Drew Dahl, Jim Fuchs, Andrew Meyer, and Michelle Neely, *Compliance Costs, Economies of Scale and Compliance Performance*, DIVISION OF BANK SUPERVISION, FEDERAL RESERVE BANK OF ST. LOUIS, figure 3 (2018). Available at <https://www.communitybanking.org/~media/files/compliance%20costs%20economies%20of%20scale%20and%20compliance%20performance.pdf>.

<sup>111</sup> Dahl, Fuchs, Meyer, and Neely (2018), *supra* note 110, figure 1.

<sup>112</sup> For a more detailed discussion of the outlay issue, see DURKIN AND ELLIEHAUSEN, *supra* note 12, at 88-95.

relatively easy, especially when the dealer also provides the financing, and very hard to regulate. Many parts of Regulation Z proceed by example, identifying costs that are, and are not, part of the cost of credit. Even if the list is completely comprehensive at the moment it is enacted, the categorization of fees creates incentives to develop new or different fees that can make the disclosure look “better” to the consumer. When a new example arises, as it inevitably will, proper application of the rule is both complex and uncertain, and private plaintiffs have strong incentives to argue that it should have been resolved differently. The result has been a continuing cycle of regulatory change, market changes, and a new round of regulatory changes, with a new wave of compliance burdens. The benefit to consumers is elusive, at best, who may do just as well choosing a loan term that fits their budget and purchasing the deal with the lowest monthly payment.

A second conceptual issue is that the “true” cost of credit depends on unknown future events.<sup>113</sup> The issue is most apparent with credit cards, where the cost of credit depends, among other things, on the extent to which the consumer taps the available credit and whether they pay off the balance or revolve it. Similarly, the true APR on a mortgage with points will change depending on whether, or when, the consumer sells the property or refinances the loan. And of course, with variable interest rates on both credit cards and mortgages, future interest rate changes may have an important influence on the total cost. We can make assumptions to do the required calculations—that the 30-year fixed-rate mortgage will be paid off according to the contract and not before—but such assumptions are both arbitrary and wrong for many of the consumers the disclosure is supposed to benefit.

Policymakers need to rethink Truth in Lending disclosures from the ground up. The starting point should be a careful consideration, based on consumer research, of the information that most consumers need most of the time to make a decision about a particular form of credit. Consumers need access to the details of the credit arrangement, but that is a more appropriate role for the contract than for disclosures. Disclosures should highlight the most important elements of the transaction. A disclosure that repeats the contract is likely to meet the same fate as the contract itself, remaining unread until a term becomes relevant.

For closed-ended credit, it would seem that consumers need five essential pieces of information: the annual percentage rate, the finance charge, any cash due at closing, the periodic payment, and the amount and term of the loan. This approach leaves the unknown future events question to consumers themselves, who must take into account their own future plans and circumstances

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<sup>113</sup> For a more detailed discussion of the unknown future events issue, see DURKIN AND ELLIEHAUSEN, *supra* note 12, at 95-106.

with or without disclosure. Regulatory hair splitting will not make the decision any easier for consumers.

For open-end credit, it would seem that the key information is the contract interest rate, again defined and disclosed in a standardized fashion, and any regular, recurring fixed fees that a consumer must pay, such as an annual or monthly fee for use of the line of credit.

## 7.6 The Future of Disclosures

Evaluating disclosures requires identifying the purpose of the disclosure. Our focus in this section is on disclosures intended to provide additional information that may be useful to consumers facing purchasing decisions, and we do not specifically address other types of disclosures.

We recognize, however, that there are other appropriate uses of disclosure. Some disclosures are intended to reduce the extent to which consumers might take away a misleading message from a marketing communication. These disclosures aim to remedy or prevent deceptive practices from misdirecting consumer choices. By their nature, they are idiosyncratic, with the disclosure details depending on the particulars of the claim that provoked the need for clarification or limitation.

Other disclosures may serve primarily to document the details of a transaction. In a mortgage transaction, for example, consumers likely need a detailed listing of various charges to determine which fees are tax deductible, and ultimately to determine correctly their gain or loss when the property is sold. Similarly, the itemized list of transactions on a credit card statement serves to document where the money went for purposes of budgeting, and to enable the consumer to identify incorrect or inappropriate charges. Neither type of disclosure is intended to influence purchasing decisions.

Instead, our focus is on recurring disclosures that provide additional information. Truth in Lending is the prototypical example of such a disclosure related to financial transactions. In other contexts, nutrition labels, gas mileage information, and energy efficiency levels are examples of this type of disclosure.

### 7.6.1 The Need for Clear and Realistic Goals

Controlling information overload requires careful attention to which disclosures are really necessary, and really useful to consumers. As we noted above, once adopted, disclosures tend to last forever, even if the problem they are addressing does not. Assessing the continued utility of

a particular disclosure, however, requires a clear picture of the goals it was adopted to accomplish.

Disclosure is a valuable regulatory tool, but it is not the answer to all consumer protection problems. When disclosures are required, it should be with a clear, and articulated, goal in mind. Too often, however, disclosures have been adopted for a wide variety of reasons, in the belief that they will accomplish tasks for which there is little or no evidence that they are an appropriate tool. As noted earlier in this chapter, Truth in Lending requires many disclosures, but somewhat surprisingly, it has more goals than disclosures. Durkin and Elliehausen's study of Truth in Lending identified 38 distinct goals, grouped into eight categories, ranging from specific credit market goals to general philosophical and educational goals.<sup>114</sup> For open-end credit, Durkin and Elliehausen's list of required disclosures is "only" 31 items. A statute with so many "goals" is unlikely to accomplish them all and offers no guidance on resolving conflicts between goals in specific circumstances. The NCCF identified a set of goals or "functions" limited to the shopping function, the descriptive function (i.e., the choice between credit and either deferral or payment from liquid assets), and the economic stabilization function (consumer could not respond to lower interest rates in a recession if they were not aware of the rate),<sup>115</sup> but the problem of conflicting goals remains.

Disclosure is well adapted to addressing problems that stem from high costs of obtaining information, but only if it is successful in reducing those costs. As discussed at the beginning of this chapter, if it is cheaper to acquire information, consumers will acquire and use more information. Unfortunately, excessive disclosures can also increase the cost of acquiring information, and in that case, disclosures will have the opposite effect—consumers will use less information to make their decisions.

In the view of the Taskforce, disclosures that provide additional information must seek to reduce the costs to consumers of locating the product or service they want. Disclosures should be focused on standardizing terms and facilitating comparability because these approaches can potentially reduce the costs of obtaining information. Disclosures should be tightly focused on information that is important to consumers and directly relevant to their purchasing decisions to avoid the problem of information overload. Disclosing all possible details and contingencies may appear to *provide* more information, but as discussed above, consumers may actually *use* less information.

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<sup>114</sup> See DURKIN AND ELLIEHAUSEN, *supra* note 12, at 173-174.

<sup>115</sup> See the NCCF Report (1972), *supra* note 1, at 171-174.

The most appropriate use of disclosures is to correct problems in the market for information. The threshold inquiry should be to identify the specific problem that impairs the provision of important information. Information is often not provided because most consumers are not interested in the information, but disclosures will not correct that lack of interest—consumers will simply be uninterested in the disclosures. If, on the other hand, comparing competing offerings is difficult because different providers use different terms or calculate key parameters in different ways, a standardized definition can reduce the costs of information and facilitate informed choice.

A more problematic use of disclosures is what some have called “normative disclosures.” These disclosures provide information not because consumers are interested, but because the policymaker thinks that consumers *should* take it into account.<sup>116</sup> These disclosures use information but as a means to nudge consumers toward a behavior that is thought more desirable than their actual behavior. Disclosures attempting to reduce the cost of acquiring information respect consumers’ preferences and provide them with the information they need to accomplish their goals. Normative disclosures seek to change their goals.<sup>117</sup>

One clear example is the required minimum-payment warning on credit card statements, which indicates how long it will take to pay off the outstanding balance by making only the minimum payment, and in many cases the payment required to pay off the balance in three years. The statement is more aimed at nudging consumers to pay more than the minimum payment than at providing useful information. The information is only of use to consumers who contemplate paying only the minimum indefinitely, and who plan to stop using the card in the meantime. By one estimate, that amounts to only 4 percent of consumers.<sup>118</sup>

The drawback of normative disclosures is that they contribute just as much to information overload as any other disclosure. Even worse, there is no clear limiting principle about which behaviors policymakers should try to influence, leading to the potential for significant increases in the information load confronting consumers. Attempting to nudge consumers in a “desired”

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<sup>116</sup> Todd J. Zywicki, *Market-Reinforcing versus Market-Replacing Consumer Finance Regulation*, in HESTER PEIRCE AND BENJAMIN KLUTSEY, EDS., *REFRAMING FINANCIAL REGULATION: ENHANCING STABILITY AND PROTECTING CONSUMERS*, 237 (2016). See also Tom Durkin, *Requirements and Prospects for a New Time to Payoff Disclosure for Open-End Credit Under Truth in Lending*, FEDERAL RESERVE BOARD, FINANCE AND ECONOMICS DISCUSSION SERIES, (2006).

<sup>117</sup> Normative disclosures and “nudges” are distinct from financial literacy education efforts. Education seeks to teach consumers how to make better decisions by better understanding financial decisions and their consequences. A nudge seeks to push consumers to a favored conclusion.

<sup>118</sup> Zywicki, *supra* note 116.

direction therefore undermines the effectiveness of disclosures that actually seek to reduce information costs and may result in consumers making worse choices with less information.

## 7.6.2 Disclosure Requirements for the Information Age

We increasingly live in a world in which information is available on demand—not by reading through a lengthy document, but rather by more focused inquiries about particular product features or particular terms of an offer. Policymakers should rethink disclosure requirements, and how they apply in this environment. Rethinking should take into account that the appropriate goal for disclosures is to reduce the costs to consumers of locating the products and services they prefer.

We suggest that the focus for regulation of online information should be availability, rather than disclosure. Information about any term of the transaction or feature of the product should be readily *available*, but choosing which terms to consider should be up to the consumer. By “available,” we mean that a website would provide, in a prominent location, links to any offer details that may be of interest to a particular consumer that is no more than two clicks away. Certainly, providers could highlight key terms of the transaction at the point of the link, and if there is clear evidence that most consumers want a particular item of information (e.g., the APR or the contract interest rate), it may be appropriate to require that information be provided at the point of the initial link.

As noted above, consumers ultimately decide which terms they attend to in any event, but “linear” disclosures mean that terms of little interest to the consumer interfere with their ability to locate the information they want. Scrolling through a required disclosure that provides all needed information is more likely to encourage consumers to scroll quickly to the bottom and click “accept” than it is to encourage careful consideration of the information provided. That is certainly what happens with the “terms and conditions” of online services and offerings. Online disclosures, however, need not be linear: Separate links that allow consumers to obtain more information about any term of interest can facilitate the information acquisition process. Such an approach would also generate data regarding what information is of most interest to consumers; most consumers will choose not to pursue all the details.

Information availability should facilitate competition to better inform consumers. Many, perhaps most, innovations in providing information at the time it is needed are likely to result from market competition, as sellers seek to provide consumers with the information they want when they want it. The information aggregators discussed above are a clear example. The proliferation of offers of timely information such as low-balance alerts or alerts about potentially erroneous transactions are driven by competition among financial service providers. So are apps such as Capital One’s widely advertised Eno, which offers alerts about possibly mistaken credit



card transactions, or apps that search credit card statements for recurring charges that a consumer may have forgotten.

“Just in time” disclosure, providing information at the point at which it is needed, is a promising approach to providing information, as the private-market examples make clear. Establishing such systems by regulation, however, seems exceedingly difficult. In the case of unexpected credit card transactions, for example, most consumers likely do not want an alert about each and every transaction on their card, especially if the account has multiple users. The constant flow of alerts would defeat the purpose of flagging potentially problematic transactions because it would effectively flag nothing. Market-driven service providers have the right incentives to limit alerts to transactions that are most likely to be of interest to the consumer, and to allow consumer choice of the level of alerts to the extent possible. Market incentives are not always perfect, but they are likely better, and certainly more responsive to changing circumstances, than a regulator’s attempt to discern which facts must be provided. What current disclosure requirements make clear is that, to date, the regulatory incentive has been to disclose everything because it might be important to someone in some circumstances. That instinct is simply incompatible with “just in time” disclosure.

We recognize that some consumers need an alternative to online access to information, but that population is likely to be a significantly decreasing fraction of the population. A backup, paper-based alternative for some is likely to remain necessary for some time. Both because consumers are familiar with the existing system and because change is costly for those who must comply, these alternatives should change as little as possible from the present disclosure system. It is, however, far past time to rethink disclosures in the information age, which opens up a whole new range of possibilities.

## 8. Competition and financial consumer protection

In the United States, consumers acquire goods and services in markets. Most familiar are retail markets, where consumers shop for the necessities and comforts of life, from groceries and garments to housing and health care. Less visible are intermediate markets through which the streams of commerce flow as natural resources and human talent are transformed into finished products and services. Every exchange along the way holds the potential to add a cost to that commerce. The availability and affordability of everything that consumers buy depends not just on the expense of making and improving it, but also on the efficiency and effective regulation of every market through which it passes.

Efficient markets need not look alike. Exchanges as different as weekend farmers' markets, multilevel shopping malls, and worldwide electronic exchanges can all be effective means of matching buyers and sellers. Indeed, the variety of shapes, sizes, and dynamics that markets assume reflects adaptability to the preferences of their participants, another indicator of efficiency. For all the differences, however, efficient markets do have two characteristics in common: In every efficient market, one can expect to find competition and credit. In the field of economics, that expectation is part of the Efficient Market Hypothesis (EMH).

EMH posits that markets work best for buyers when they can choose among competing sellers. The same holds true for sellers seeking buyers. A market does not work for a trader who cannot find anyone willing to transact business at any price. Not much better is the market where buyers find just one vendor or sellers encounter only a single customer. A market cannot even begin to work for people who have value to exchange but are excluded from participating. Marginalized groups gain nothing from markets that are not open to them. These situations are examples of market failures. It is when a market attracts buyers and sellers in sufficient numbers to compete for the patronage of one another, and is open to all who are willing and able to trade, that it is most likely to reward them with fair value in exchange for what they bring to trade.

For consumers, access to fair and high-quality credit is the key to the marketplace. Consumers rarely come prepared to barter goods or services in exchange for something they want to buy.

Instead, they come with financial instruments that merchants will accept. Those instruments are a form of credit. Without personal credit or currency (the credit of a separate trusted source) that vendors will accept, consumers cannot obtain the goods and services that the most efficient and competitive markets might offer.

Financial services—the means by which people spend, save, and borrow—reach consumers through markets as well, and the same factors of efficiency and failure apply. A financial market is not working if people who can afford financial instruments cannot acquire them, because the market is closed to them or has failed - for example, when minority borrowers struggle to access credit for which they are qualified. Nor is it working when providers of financial services can escape the discipline of competition and charge premiums for the services that are available. Expensive, ineffective, or discriminatory financial instruments exact a toll on every transaction in which they are involved.

Consumer protection can enhance the performance of markets and the quality of the goods and services exchanged in them. Deception, abuse, and discrimination are antithetical to efficient markets, which rely on voluntary and informed exchange to produce the best outcomes. Law enforcement that suppresses misappropriation, extortion, discrimination, and other acts of malfeasance therefore improves market performance. It is the goal of consumer protection to prevent this behavior, and to remedy the injuries that occur when such practices occur.

Consumer protection can also reduce the impediments to market performance that stem from mistakes and confusion. Because uncertainties and misunderstandings can accompany transactions, especially those that span months or years, a well-functioning market relies on rules and procedures that deal with consumer understanding, unanticipated mistakes, economic distress, and contractual breaches in an efficient manner. Such rules and procedures make up an important component of effective consumer protection.

With potential hazards coming in many forms from many sources, no single measure can protect consumers from them all. Likewise, no single solution can remedy every injury that consumers may suffer. Accordingly, a robust regime of consumer protection deploys a combination of approaches and measures. The Dodd-Frank Act gave the Consumer Financial Protection Bureau (CFPB) a full complement of consumer protection tools, and these are described in other chapters. This chapter concerns a tool that is often overlooked in discussions of consumer protection and the Bureau's powers – the preservation of competition.

Before the Dodd-Frank Act laid out the powers of the Bureau, the statute described the purpose of the agency and objectives that Congress intended it to pursue. A single sentence stated the 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.<sup>1</sup>

Elaborating on that purpose is a set of objectives, each of which, implicitly or explicitly, gives a role to competition:

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.<sup>2</sup>

These objectives rest on the proposition made explicit in the purpose of the Bureau—that competition is a principle component of consumer protection along with fairness and transparency. The first objective is to ensure the flow of information that enables consumers to choose wisely among competing alternatives. The second objective is to use the Bureau’s regulatory powers to protect consumers from unfair, deceptive or abusive acts and practices, to protect consumers from discrimination, and to provide fair, equitable, and non-discriminatory access to credit for consumers and communities. The third objective, reducing unwarranted regulatory burdens, removes unnecessary costs, which can impede competition from smaller companies and raise prices beyond consumers’ reach. With respect to the fourth objective, the congressional call for enforcement that gives no advantage to any sector could not be a clearer mandate for fair competition among financial service providers. As for the fifth, the goal of preserving markets that facilitate access and innovation refers to the most recognized aspects of

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<sup>1</sup> 2 U.S. Code § 5511 (a).

<sup>2</sup> 12 U.S.C. § 5511(b).

effective competition—welcoming customers, lowering costs, and improving products. This objective also highlights one of the most dynamic aspects of competition in the financial sector. Major advances in the history of consumer finance have been marked by innovations that made credit more convenient, more accessible, and less expensive.

In emphasizing the importance of competition to the mission of financial consumer protection, Congress drew upon a consensus that has enlightened trade regulation for centuries. The consensus includes a large body of academic research conducted in the 1970s, a century of federal economic policy, and a report drafted by a commission that Congress created 50 years ago, the National Commission on Consumer Finance (NCCF)<sup>3</sup>. After two years of research into many facets of consumer finance, the NCCF reported in its introductory letter that “a truly competitive consumer credit market, with adequate disclosure of relevant facts to an informed consuming public, together with legislation and regulation to eliminate excesses, will foster economic growth and serve to optimize benefits to the consumer.”<sup>4</sup> These benefits need not come at the expense of consumer protections. To the contrary, explained the NCCF, “painful as competition may be for the participants, it provides the ultimate protection for most consumers.”<sup>5</sup> In the consumer credit marketplace, with the information mandated by the Truth in Lending Act, NCCF favored competition as the “best means to assure that most consumers pay a fair price for their credit services.” Competition under current law was ineffective in some areas, the NCCF concluded, particularly in addressing the problems of low-income consumers living in low income areas. That required special attention.

“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.”<sup>6</sup>

Likewise, the NCCF envisioned an important role for antitrust enforcement, which should be “particularly alert to the dominance of consumer credit markets by a few firms, by barriers to

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<sup>3</sup> 220.15.4 Records of the National Commission on Consumer Finance (History: Authorized by the Consumer Credit Protection Act (82 Stat. 164), May 29, 1968, to evaluate the consumer finance industry, in particular consumer credit arrangements. Activated by Presidential announcement, November 7, 1969, with first meeting held December 11, 1969. Chaired by law professor Robert Braucher, November 7, 1969-January 21, 1971; and attorney Ira M. Millstein, January 22, 1971-December 31, 1972. Terminated upon submission of final report, December 31, 1972, published as *Consumer Credit in the United States*.) See <https://www.archives.gov/research/guide-fed-records/groups/220.html>.

<sup>4</sup> Ira M. Millstein, Letter to the President and Congress, December 31, 1972.

<sup>5</sup> Report of The National Commission on Consumer Finance, *Consumer Credit in the United States*, 214 (Dec. 1972).

<sup>6</sup> *Id.* at 4.

entry, and to restrictive arrangements in the credit industry.”<sup>7</sup> Antitrust enforcement could not be expected, however, to remove competitive impediments that were anchored in regulation that insulated them from challenge. The NCCF therefore advocated the repeal of laws that fixed rates or restricted services that consumers could access in competitive markets, and it urged the removal of legal barriers segregated financial institutions into sectors and prevented lenders in one from serving borrowers in another.<sup>8</sup>

That competition is critical to consumer protection was neither novel nor controversial when the NCCF espoused the idea in 1972. The best-selling economic textbook of the time (indeed of all time) was teaching the same lesson to college students and demonstrating how that lesson applied to credit markets.<sup>9</sup> Professor Paul Samuelson, who had won the Nobel Prize in Economics in 1970, explained in his text that year how competition can empower borrowers to obtain credit “at the cheapest possible terms” just as it allows shoppers to get the best prices from butchers.<sup>10</sup> He had made the same point to the Massachusetts legislature in 1969, when he testified on the proposed Uniform Consumer Credit Code:

A great deal of practical experience has accumulated among our various states and from careful comparisons across countries, to show that the consumer is most improved by effective...competition so that a range of alternatives are open to each consumer and so that each lender knows that his monopoly power to exploit the needy borrower is severely limited by these alternative opportunities. The same principles have been found to prevail in the market for small-loan finance as in the markets for the necessities of life.<sup>11</sup>

Like the NCCF, Samuelson did not expect competition to address all the problems of consumers and society. Acknowledging areas where pure free market competition might be less effective, in his eighth edition of this textbook, he added two additional chapters: 1) “Economic Inequality: Poverty, Affluence, and the Quality of Life” and 2) “Economic problems of Race and the Cities.”<sup>12</sup>

Samuelson was far from the first economist to recognize the importance of competition, its role in protecting consumers, and its application to finance. Similar observations can be found in the

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<sup>7</sup> Id. at 3

<sup>8</sup> Id.

<sup>9</sup> PAUL SAMUELSON, *ECONOMICS*, 8<sup>th</sup> Ed. 578-79 (1970). The remarkable popularity of the textbook is reported in Elzinga, Kenneth G., *The Eleven Principles of Economics*, SOUTHERN ECONOMIC JOURNAL, 58:4, 861-79 (1992).

<sup>10</sup> Id., at 579.

<sup>11</sup> Statements of Former Senator Paul Douglas and Professor Paul Samuelson on the Uniform Consumer Credit Code to the National Conference of Commissioners of Uniform State Laws, January 29, p. 8 (1969).

<sup>12</sup> Israel Shenker, *Book Review of ‘Economics,’ Samuelson*, 8<sup>th</sup> ed., New York Times, Feb. 5, 1970.

work of Adam Smith, often regarded as the original economist.<sup>13</sup> In a treatise he published in 1776, “The Wealth of Nations”, Smith observed that the market, like an “invisible hand,” would direct sellers’ self-interest to the service of buyers.<sup>14</sup> His prediction came with a critical caveat, however: The market had to be competitive for buyers to benefit from the invisible hand. Smith concluded that the best incentive to keep a seller honest and fair was the fear of losing customers to a competitor. That was the “real and effectual discipline” that “restrains his fraud and corrects his negligence.”<sup>15</sup> And to Smith there was no question whether the principle applied to financial firms. Competition among banks, he said, “obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away. In general, if any branch of trade, or any division of labor, be advantageous to the public, the freer and more general the competition, it will always be more so.”<sup>16</sup>

By 1972, a consensus had formed among economists as to the circumstances that advance competition and the conditions that impede it. The NCCF drew upon this consensus and applied the analytical framework to the observations and data from the history of credit markets. For the most part, the conditions that qualified as catalysts of competition and contributors to consumer welfare remain recognized as factors that contribute today.<sup>17</sup> By the same token, the obstacles identified as impediments to competition and costs to consumers have been found again and again to impair markets across the economy. Those circumstances and their effects—both favorable and unfavorable—will be the focus of this chapter.

Nothing in the fundamentals of financial markets suggests they would suffer from a lack of competition. The principal resources—financial and human capital, communication and information technology—are readily available and highly mobile. Financial intermediaries need offices, of course, but not the massive mines and factories of heavy industry to extract raw materials and process them into finished goods. Transportation costs are miniscule for both the

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<sup>13</sup> See SAMUELSON (1970), *supra* note 9, at 1. The coincidence of Smith’s publication with another notable event in 1776, the Declaration of Independence, was not by chance, said Samuelson: “[P]olitical freedom from the tyranny of monarchy was closely related to the emancipation of free-market pricing from the interfering hand of state regulation.”

<sup>14</sup> ADAM SMITH, *WEALTH OF NATIONS*, 14 (1776). Smith also recalled the butcher in explaining the working of a free market. In one of the most famous passages from the treatise, he wrote, “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.”

<sup>15</sup> *Id.*, at 129.

<sup>16</sup> *Id.*, at 313 (Smith also explained how competition encouraged prudence, and in a premonition of modern concerns about institutions too big to fail, hypothesized how competition could diminish the risk of financial system failures.)

<sup>17</sup> See, e.g. American Bar Association, *Antitrust Law Developments*, 8<sup>th</sup> ed. (2017) (surveying literature and cases).

inputs that the institutions acquire and the outputs they deliver; funds of any amount can move cheaply and easily to most of the population.

To be sure, financial intermediation—from the acquisition of capital to the delivery of services—requires efficient organizations, talented personnel, and sophisticated business models. Institutions with expertise and scale are more likely to succeed in obtaining capital at low costs and offering financial services on attractive terms.<sup>18</sup> Some services require national and global networks to be feasible and desirable, and some regions present challenges for the delivery of services. Above all, a reputation for integrity and reliability is a critical credential in financial affairs, and a history of honorable behavior confers credibility. Successful incumbents are likely to have such advantages over newcomers.

But incumbents with advantages over newcomers are neither unique to financial services nor incompatible with competition. Companies can multiply and industries can grow even when economies of scale and venerable reputations give advantages to familiar firms. Nowhere has this been more evident than with consumer credit, which has seen new entrants, innovative products, aggregate growth, reinvention of incumbents, and decline or departure of companies that could not keep pace with the others. These are the hallmarks of competitive markets.

Notwithstanding propitious conditions and encouraging indications of competition in credit, the NCCF identified numerous problems that prevented financial markets from performing as effectively as a competitive market would be expected to do. As described below, the impediments included various forms of restrictive licensing, limitations on services that companies could provide, geographical and sectorial barriers between institutions, and other conditions that made credit needlessly expensive to some and entirely unavailable to others. Some of the impediments were imbedded in regulation and legislation; others stemmed from perceived anticompetitive behavior in the industry.

These concerns warrant reexamination. If such conditions persist today, they could be thwarting or diminishing the forces that would otherwise have given consumers the benefits of better rates, greater access, and more services that robust competition can deliver. This chapter first reviews the NCCF's findings and recommendations on the state of competition in consumer finance and considers some of the costs that competition could have averted. Next, the chapter describes the evolution of credit markets since the NCCF's report and assesses trends that help explain the competitive circumstances consumers face today in credit markets. In the course of

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<sup>18</sup> A study performed for the Commission noted relatively modest scale economies for loan offices. CR 286, n.3. See Chapter 4 of this report for a discussion of economies of scale in finance.



the discussion, the chapter identifies measures that could improve the quality, quantity, and affordability of financial services available to consumers.

## 8.1 Credit and Competition in the Post-World War II Economy

The end of World War II and the revival of the consumer economy marked the period that occupies most of NCCF's analysis of credit and competition. For the terms of that analysis, the NCCF resorted to a familiar definition: "When the number of sellers is so large and entry is so easy that no seller has power over price," competition could be expected, but not guaranteed, to make credit affordable and available.<sup>19</sup> A competitive market could be expected to lower prices to the lowest level consistent with covering production costs and profitability just sufficient to bring capital into the industry. Credit availability was measured by "the degree to which creditors are willing to provide credit at the free-market rate in a world without imperfections."<sup>20</sup> In other words, the NCCF viewed competition to have the most potential to offer the lowest rates for consumers and achieve the greatest access to credit in a perfect world. The Report then assessed the state of that competition and whether it was delivering the expected results.

The NCCF found varying degrees of competition in consumer finance markets in the early 1970s. Interest rates appeared to respond to supply and demand, and consumers seeking credit generally could obtain it at market rates. But the NCCF also found differences in access and variations in rates across states and sectors. Depending on where consumers lived or borrowed, some paid higher rates and borrowed less, while others enjoyed lower rates and borrowed more—disparities that could not all be attributed to capital costs other fundamentals. Moreover, when credit was expensive and rare, it often coincided with indications of competitive shortcomings.

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<sup>19</sup> Id. at 109.

<sup>20</sup> Id. at 112-13 (In an ideally competitive market, rates reach competitive equilibrium levels through a series of adjustments by suppliers of various credit offers to various risk classes of consumers.' These rates are high enough to cover costs and enable creditors to earn a normal return on invested capital. Creditors are willing to extend any

amount of credit to qualified borrowers at such rates, and the situation can be characterized as one of full

availability.)

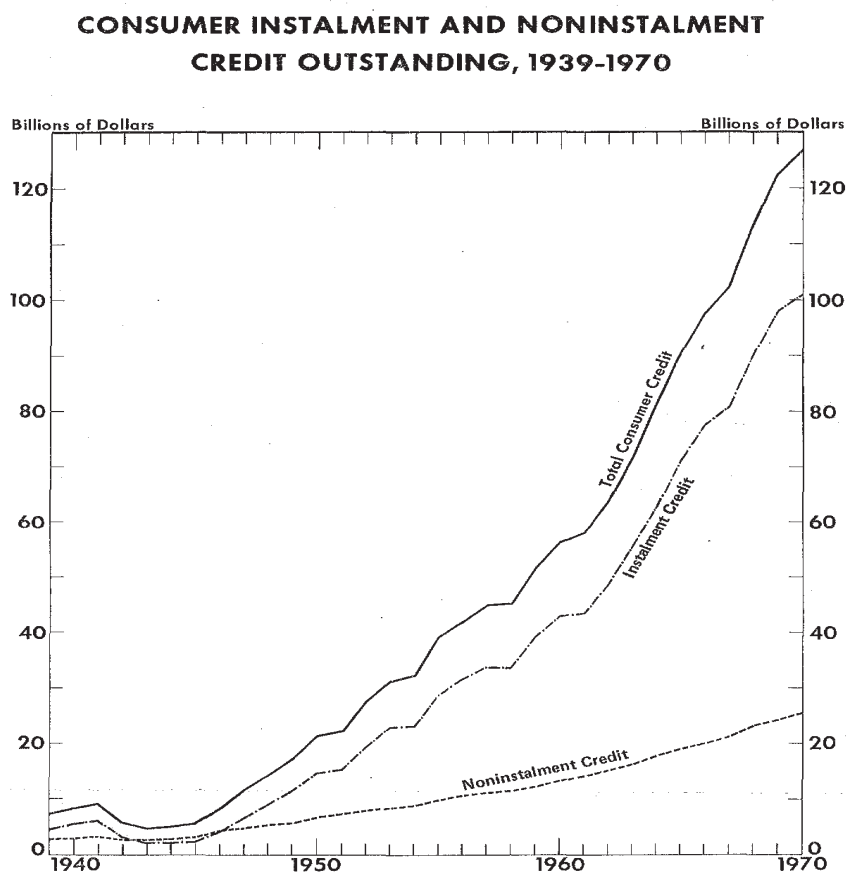
### 8.1.1 National Trends

In a national overview of consumer credit, the NCCF focused on different sectors of financial service providers. Some sectors had consolidated, some had disaggregated, and others had seen cycles of both. Overshadowing all the sectoral analysis was the dramatic growth in sources of consumer finance. A chart in the Report displayed the trends in consumer credit broken down by repayment methods, either installment or noninstallment, the latter including single payment loans, nonrevolving credit, money owed to service providers, and similar debts, and the growth took a dramatic upward turn in 1945, as did the US economy that grew at its fastest sustained pace in a century between 1950 and 1973:<sup>21</sup>

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<sup>21</sup> C.I. Jones Stanford GSB, *The Facts of Economic Growth*, in HANDBOOK OF MACROECONOMICS, Volume 2A Exhibit 2 -1, at 9 (2016), available at <http://dx.doi.org/10.1016/bs.hesmac.2016.03.002>, NBER, available at <http://web.stanford.edu/~chadj/facts.pdf>.

**FIGURE 8-1: CONSUMER INSTALMENT AND NONINSTALMENT CREDIT OUTSTANDING, 1939-1970**



Among the factors fueling this growth were tens of thousands of potential competitors in the business of making loans to a population that was booming, urbanizing, and challenging the customs and restrictions that society had long imposed. Some 13,600 commercial banks held more than \$50 billion in consumer credit in 1970, more than any other segment and about 40 percent of the total outstanding in the United States.<sup>22</sup> Finance companies—about 3,700 in 1965, operating out of an estimated 13,000 to 14,000 offices—accounted for the second largest portion, with 30 percent of the consumer credit outstanding. Outnumbering both banks and finance companies were 23,650 credit unions, although their share of credit outstanding came in lower, at 12 percent in 1970. Probably more numerous than any other sources were retailers, who held about 14 percent of consumer credit outstanding as the 1960s ended, but a precise tally of their number was not available.<sup>23</sup> Outside these main categories, other lenders (such as

<sup>22</sup> *Id.* at 8.

<sup>23</sup> *Id.* at 11

savings and loan associations and mutual savings banks) amounted to about 1.5 percent of the credit outstanding.<sup>24</sup>

Dollar volumes of the holdings of these sectors reflected the dramatic growth of installment credit outstanding—from under \$15 billion to more than \$100 billion—over the two decades ending in 1970.<sup>25</sup> Banks and finance companies each held more than twice as much as all the institutions combined just 20 years earlier. Credit unions and retailers each held almost as much as the entire amount outstanding in 1950.

**FIGURE 8-2:** EXHIBIT 2-4 OF THE COMMISSION'S REPORT SHOWED THE VOLUMES AND SHARES OF INSTALLMENT DEBT<sup>26</sup> BY INSTITUTIONAL SECTORS IN 1950 AND 1970.

	Amounts outstanding (Dollar amounts in millions)			
	December, 1950		December, 1970	
	<i>Amount</i>	<i>Percent</i>	<i>Amount</i>	<i>Percent</i>
Commercial banks .....	\$5,798	39.4	\$41,895	41.4
Finance companies .....	5,315	36.1	31,123	30.8
Credit unions .....	590	4.0	12,500	12.4
Miscellaneous <sup>a</sup> .....	102	0.7	1,546	1.5
Retail outlets .....	2,898	19.7	14,097	13.9
Totals .....	\$14,703	100.0	\$101,161	100.0

<sup>a</sup>Miscellaneous lenders include savings and loan associations and mutual savings banks.  
Details may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System.

Aggregate growth bodes well for competition, as it is easier for new companies to enter and small rivals to thrive in a market that is expanding. Customers in a market for the first time are less likely to have developed loyalty to an established firm. And entry itself can accelerate the expansion of a market, as new companies and smaller rivals hustle to establish themselves and grow their businesses.

One indicator of competition is the volatility of market shares of the sellers in a market, as credit unions, finance companies, commercial banks, and Morris Plan Banks had demonstrated before the war. Changing shares can reflect rivalry among firms already within a market, entry of new firms into the market, and innovation that disrupts historic patterns. When established firms

<sup>24</sup> Id.

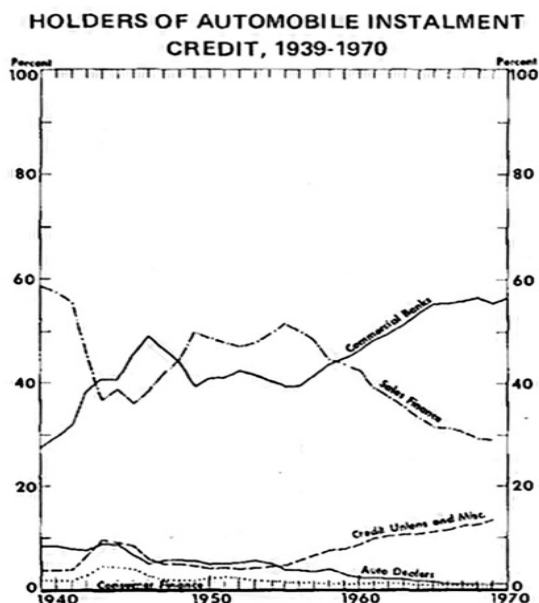
<sup>25</sup> See Table 2-1 in CICO Chapter 2 for a longer series.

<sup>26</sup> NCCF, *supra* note 5, at 11.

charge more than necessary to cover the costs of providing the goods and services they sell, the resulting profits invite entry by others. Inferior quality, untapped innovation, and poor service are other signals that alert existing and potential competitors to the prospect of rewards for anyone who can improve upon the status quo. New entrants and opportunistic rivals empower consumers to discipline companies who do not perform. Such discipline can manifest itself in the movement of consumers from one seller to another, in the movement of companies to into and out of a market, and in the revitalization of underperforming incumbents. In markets where consumers can shift their allegiance, market power is unlikely to persist for long, if it arises at all.

The NCCF tracked shares of the institutional sectors that held consumer credit in the decades ending in 1970. At first glance, shares appeared relatively stable. Banks, with 31 percent in of installment credit in 1970, had added two percentage points to their 1950 share of 29 percent. Finance companies and retailers lost about five and six points from their 1950 shares of 36 percent and 20 percent, respectively, while credit unions added eight points, impressive growth on a percentage basis given the 4 percent that the sector held at the beginning of the period. Still, credit unions remained in fourth place among the four main categories of consumer lenders nationally.

**FIGURE 8-3: HOLDERS OF AUTOMOBILE INSTALMENT CREDIT, 1939-1970**

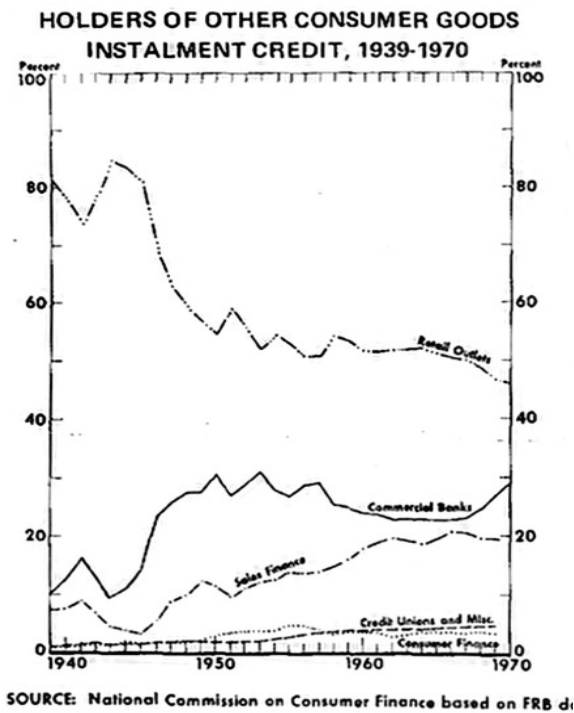


The picture changes dramatically when these sectors are examined more closely. In loans for automobiles, home appliances, and home improvement—rapidly growing industries in the post-war economy—institutions gained and lost shares to an extent that belied the seeming stability of their positions at the beginning and end of the period. For example, sales finance companies (many affiliated with the automobile industry) dominated lending for vehicles in 1940, with nearly 60 percent of the credit outstanding, twice the share of commercial banks.<sup>27</sup> The lead did not last long. In just a few years, banks bypassed finance companies and were making about half the overall lending for autos in the late 1940s. Finance companies recovered just as quickly, overtaking banks and maintaining the lead source of auto loans for most of the 1950s. But as the 1960s loomed, banks once again had resumed their growth, finishing the decade with almost twice the share of their chief rivals. By 1970, in a much larger market, banks held nearly 60 percent of the auto installment credit, twice as much as the finance companies. It was also in the late 1950s and 1960s that credit unions grew steadily. More than 30 percent of their loans in 1971, amounting to more than \$3 billion, financed auto purchases.<sup>28</sup> Meanwhile, the small share attributable to auto dealers nearly disappeared.

<sup>27</sup> NCCF (1972), *supra* note 5, Exhibit 2-5 of the Commission's report illustrated these shifts.

<sup>28</sup> NCCF (1972), *supra* note 5, at 12

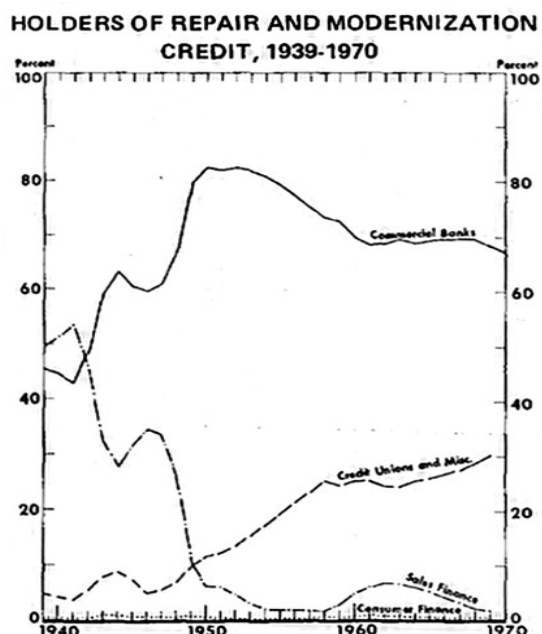
**FIGURE 8-4: HOLDERS OF OTHER CONSUMER GOODS INSTALMENT CREDIT, 1939-1970**



In the market where consumers sought to finance purchases of expensive appliances, furniture and other items at retail stores, the retailers who sold the goods began the period with a seemingly commanding lead over the other sources of credit, only to take a precipitous fall. In the early 1940s, retailers held more than 80 percent of installment credit in this category. By 1970, their share had dropped below 50 percent. Commercial banks and sales finance companies more than doubled their shares over the same period, reaching about 25 percent and 20 percent, respectively.<sup>29</sup>

<sup>29</sup> Id.

FIGURE 8-5: HOLDERS OF REPAIR AND MODERNIZATION CREDIT, 1939-1970



In one category of credit the segment leader virtually disappeared. Sales finance companies held half the outstanding credit for modernization and repair in the early 1940s. Banks were a close second, with credit unions far behind. By 1970, sales finance companies' share was approaching zero. Banks and credit unions each had added 25 points to their 1940 shares and finished the period with nearly all the loans for these home improvement projects. Credit unions grew sixfold, from about 5 percent to 30 percent.<sup>30</sup>

With different types of institutions vying for the same types of loans, and certain sectors taking substantial shares from other sectors, competition was obviously crossing institutional lines. Inside the sectors, the forces that the firms faced were likely more turbulent still. New entrants would have posed constant threats to established institutions. According to the National Credit Union Association, federal credit unions numbered nearly 6,000 in 1952.<sup>31</sup> The NCCF tallied more than 23,000 (likely state and federal) in 1972.<sup>32</sup> Between 1950 and 1970, banks added about 20,000 branches. Bank credit cards were growing even more rapidly by 1970. At the end

<sup>30</sup> Id.

<sup>31</sup> See, *Historical Timeline*, NATIONAL CREDIT UNION ASSOCIATION, available at <https://www.ncua.gov/about-ncua/historical-timeline>. Those entrants either brought new customers to consumer finance or took business from other credit unions or financial institutions. Most likely the newcomers did both.

<sup>32</sup> NCCF (1972), *supra* note 5, at 8.



of 1967, 390 banks reported some \$800 million in credit-card debt outstanding.<sup>33</sup> Three years later, more than 1,200 banks, still a minority, reported \$3.8 billion. Consumers were flocking to new products, new companies, and new offices. Incumbents could not afford to be complacent if they wanted to keep account holders from taking their business elsewhere.

Given the rapid expansion of credit over this period, shrinking shares still may have signified growth, albeit slower, but some sectors declined absolutely despite the expansion. Consumers, in numbers large enough to double or decimate sectors in the course of a decade or two, were rewarding companies that offered attractive terms and penalizing those that compared poorly. Later, this chapter describes how the ongoing rivalry among existing lenders and the entry of new sources of consumer credit continued to produce dramatic changes in the nature and structure of the sector since the NCCF's Report.

## 8.1.2 Differences Among Institutions and States

If national numerosity alone determined competition, then the thousands of credit sources and their churning market shares might indicate that the balance of power in these markets favored consumers, not lenders. But national trends do not reflect the conditions an individual borrower might face. The markets for most consumer financial services were local or regional in the decades the NCCF studied. Retailers offering attractive charge accounts in Pittsburgh or banks with low interest rates in Philadelphia were unlikely to help consumers in Chicago.<sup>34</sup> By the same token, consumers shopping for cars anywhere would have found credit cards and home improvement loans to be poor substitutes for auto loans. To be sure, a customer might have been able to buy an appliance or roof repair on credit in order to set aside cash for a car, but such substitution is less convenient than choosing among competing auto lenders. For reasons such as these, nationwide tallies of financial providers, aggregate shares of debt outstanding, and other structural characteristics may not reveal the vigor of competition or the alternatives available when customers are looking for credit.

The NCCF, recognizing that the relevant competition occurred in geographic markets smaller than the entire United States and in product markets narrower than all consumer credit, focused on differences among cities and states, and within sectors, in its analysis of concentration and performance.<sup>35</sup> Geography was typically broken down by states. Lines of business were defined

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<sup>33</sup> Id. at 12.

<sup>34</sup> Even commercial customers tended to bank locally, as the Supreme Court observed in an antitrust case that had found New York to be in a different banking market from Philadelphia in 1963. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1963)

<sup>35</sup> See, e.g. NCCF (1972), *supra* note 5, at 138.

by categories of credit—including automobile loans, retail installment credit, and installment credit for other consumer goods—and comparisons of access and rates in different states. For each category, the NCCF assessed quantitative and qualitative evidence bearing on competition. The quantitative factors included structural characteristics – primarily the numerosity and concentration of lenders. Among the qualitative factors were conditions allowing or impeding entry into credit markets, caps on interest rates, and business practices that could restrict competition. These circumstances were checked for potential effects on rates of interest and availability of loans.

### 8.1.3 Automobiles—

The NCCF’s cross-sectional analysis of lending in different states found both evidence of competition and indications of market power. In automobile loans, for example, “quantities of credit extended vary inversely with market power” (measured by market concentration of banks).<sup>36</sup> Also evident was a predictable corollary of lower quantities: Where quantities fell, rates rose. The analysis revealed significant correlations between bank concentration and interest rates that car buyers paid across a broad spectrum of states. A comparison of states at the high and low ends of the spectrum exposed the potential costs of the disparities. Consumers who lived in states where banks were fewer (i.e. more concentrated) paid an average premium of about 70 basis points, and they paid this premium whether they borrowed from banks or borrowed from dealers who then sold the loans to the banks.<sup>37</sup>

The difference in interest rates coincided with larger differences in the behavior of borrowers. A significant segment of consumers paid another premium when they took out auto loans in concentrated states, because when banks made fewer loans, dealers filled the gap. In less concentrated states, banks were the leading source of loans, by a wide margin. Direct bank loans accounted for 42 percent of financed sales, nearly doubling the 24 percent of the sales financed by dealers (who then sold the loans to banks or finance companies). Where banks were more concentrated, the shares reversed; sales financed by dealers (and indirectly financed by banks) outnumbered sales directly financed by the banks themselves. Dealers extended 37 percent of bank-financed loans, while banks handled 23 percent directly. In other words, dealers’ share of bank-backed financing grew by half, while direct bank lending dropped by almost the same proportion, in concentrated states. For consumers, the shift to dealer financing may have had a

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<sup>36</sup> *Id.* at 112 (In addition, in “all but a few states, rate ceilings are inconsequential as a determinant of the market rate.”)

<sup>37</sup> *Id.* at 122.

greater impact than the rise of bank rates in concentrated states, since dealers charged APRs about two points above banks' direct rates across all states.

The practical significance to consumers of 70 basis points and 2.7 percentage points can be illustrated by considering the effects of those premiums on total payments for a typical 1970 auto loan in today's dollars. An increase of 70 basis points—the direct-loan premium that the NCCF attributed to market power—would cost the consumer an extra \$200 over three years in 2020 dollars for the median loan.<sup>38</sup> An additional 2.7 percentage points—the difference between rates paid by direct borrowers in competitive states and indirect borrowers in concentrated states—would generate extra interest payments of \$900 in inflation-adjusted dollars over the life of a three-year loan.<sup>39</sup>

It is conceivable, of course, that the consumers who borrowed from dealers would not have qualified for average bank rates, and that some consumers probably preferred to pay for the convenience of borrowing at the dealer. But that does not explain such wide disparities in bank shares and dealer shares of credit extended across states. There is no reason to expect that borrowers seeking more convenience or presenting greater risk would cluster in the states where fewer banks charged higher rates.

The NCCF cautioned that other factors may have confounded the results.<sup>40</sup> For example, some of the low-concentration states had lower statutory rate ceilings, high-concentration states often allowed branch banking, and different costs may have explained some of the interest-rate variations. Thus, even though the reported correlations between concentration of banks and the borrowing patterns were statistically significant, the NCCF noted that concentration “does not inevitably result in anticompetitive behavior, nor does branch banking inevitably result in high concentration.”<sup>41</sup>

Second, the concentration levels the NCCF observed were relatively low, even in the states that fell into the highly concentrated category. In those states, the four largest banks on average accounted for 64 percent of the money lent to finance automobile purchases. Thus, more than a

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<sup>38</sup> The premium calculation assumes a loan of \$3,000 in 1970 amortized over three years. Adjusted for inflation, \$3,000 in 1970 is \$20,000 in 2020. The median auto loan in 1971 was \$3048, with a maturity of 34.5 months [NCCF at 15; CPI Inflation Calculator, <https://www.in2013dollars.com/us/inflation/1970?amount=3000>.]

<sup>39</sup> The calculation assumes a \$3,000 loan amortized over three years in 1970.

<sup>40</sup> NCCF (1972), *supra* note 5, at 122-23.

<sup>41</sup> *Id.* at 123. (Developments described later in this chapter reveal that the Commission's concern about branch banking was misplaced.)

third of the loans were made by at least three other banks.<sup>42</sup> Academic research and antitrust enforcement generally agree.<sup>43</sup>

Third, as the NCCF observed, concentration alone does not confer market power, if smaller competitors and new entrants can take business away from established companies that charge monopoly prices. High prices are signals to current and future rivals that profits are available in a market. Dominant firms need rivals constrained and entry impeded if they are to succeed in reaping the rewards of market power. In some cases, they enjoyed those conditions, and still do. These are addressed after a review of the other forms of credit in the NCCF's Report.

Qualified conclusions about the correlations between concentration and competition were warranted. First, as the NCCF noted, correlation does not indicate causation. Second, statistical significance does not equate to explanatory power. And third, the quality of the data was questionable. Important measures that were not included could have confound the results, and aggregate data that was used could be a poor proxy for conditions in local market. A study published in 1975 tested the structure-performance hypothesis with more refined data, and it emphasized the qualifications as much as the conclusions. Focusing on local markets for installment loans, Beighley and McCall found statistically significant relationships between market power and various measures of concentration, but that the relationships were not "of a magnitude to be of great operational significance in determining a bank's market power."<sup>44</sup>

## 8.1.4 Financing Retail Goods

For the category of other consumer goods (those mostly bought at retailers), the effect of rate restrictions made credit markets difficult for the NCCF to assess.<sup>45</sup> Interest rates varied little from state to state for revolving credit. Rates hovered around 18 percent, not necessarily because of competitive conditions, but due to common usury limits. The rate caps made it difficult to disentangle the effects of competition from the effects of rate ceilings. Where rate ceilings were

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<sup>42</sup> For the remainder to be accounted by three banks, each would have had a 12 percent share. If they were not equal in size, and it is rare to find such parity, then the number of additional competitors had to be greater than three.

<sup>43</sup> See, e.g. Thomas Kauper, *The "Warren Court" and the Antitrust Laws: Of Economics, Populism, and Cynicism*, MICHIGAN LAW REVIEW, Vol. 67, No. 2, pp. 325-342 (Dec., 1968); Orley Ashenfelter, Daniel Hosken and Matthew Weinberg, *Did Robert Bork Understate the Competitive Impact of Mergers? Evidence from Consummated Mergers*, THE JOURNAL OF LAW & ECONOMICS, Vol. 57, No. S3, (August 2014), pp. S67-S100.

<sup>44</sup> Beighley and McCall, *Market Power and Structure and Commercial Bank Installment Lending*, JOURNAL OF MONEY, CREDIT, AND BANKING (1975).

(Market power was measured by the Lerner price-marginal cost index, and concentration was measured by inequalities among individual bank market shares, market shares of the leading bank groups, and numbers of commercial banks.)

<sup>45</sup> NCCF, *supra* note 5 at 126.

high or nonexistent, competition kept rates below the ceilings, but where ceilings were relatively low, the NCCF detected excess demand for credit; consumers were unable to obtain loans at rates they would have been willing to pay.<sup>46</sup>

Convenience was an important factor for consumers when financing retail purchases. Credit granted at the point of purchase was more attractive than the option of going elsewhere for the funds to buy an expensive appliance or piece of furniture, and consumers took advantage of the opportunity. Banks and credit unions combined for less than 10 percent of such purchases.<sup>47</sup> Location was an obvious advantage for retailers, who did not face as much competition from other sources as, for example, auto dealers did.

Higher concentration among retailers was associated with fewer goods financed at stores, but retailer concentration varied relatively little from state to state—significantly less than in the banking sector. In the more concentrated category were states where four stores averaged two-thirds of sales, meaning more than two (likely many more, since they were smaller) made up the remainder. In less concentrated states, the top four retailers still exceeded half of all sales. Such variations in concentration did not signify competitive concerns to the NCCF. It recognized that the retail sector was highly competitive, given that it was a business easy to enter and exit, with a history that frequently displayed both.<sup>48</sup>

How much consumers actually paid for retail credit was difficult to measure, because interest rates were not the only means by which retailers could recover their costs. If an interest rate cap prevented a store from raising rates on charge accounts, it could raise the prices of the goods financed. The Report cited research showing that appliance prices in a market with low rate caps were about 5 percent higher than in nearby markets with high or no caps.<sup>49</sup> For customers, increased cash prices indicated that everyone might have been paying interest, whether they purchased with credit or cash. Consumers who paid in cash may have subsidized those who paid with credit.<sup>50</sup> The NCCF worried that such a subsidy would have amounted to a regressive

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<sup>46</sup> Id. at 124-25.

<sup>47</sup> NCCF (1972), *supra* note 5, at 126.

<sup>48</sup> NCCF (1972), *supra* note 5, at 106.

<sup>49</sup> NCCF (1972), *supra* note 5, at 106.

<sup>50</sup> Id. at 107.

transfer from poorer to wealthier consumers, since cash buyers would include those who could not qualify for charge accounts.<sup>51</sup>

## 8.1.5 Finance Companies and Other Sources

Finance companies confronted a wide variety of competitive conditions from state to state, and consumers' fortunes in the sector reflected those variations. Loans were more readily available from finance companies where economies were stronger, concentration was lower, and the companies enjoyed lower labor costs. As in retail revolving credit, competition kept rates below the legal caps in many markets, and credit was widely available in them. But again, the effects of competition on interest rates themselves were difficult to assess because usury limits in some markets often controlled rates that lenders could charge, and the volume of credit demanded at those rates exceeded the volume available. Perhaps for that reason, the correlations between concentration levels and rates were weak, and again the NCCF noted that confounding factors may have explained the associations.

## 8.1.6 Market Restrictions Across Sectors

Across all the sectors, the NCCF found disparities in consumers' access to affordable credit associated with restrictions that directly impaired competition. Where the NCCF found concentration, it often found barriers to entry and restrictions on credit practices. Restrictive Convenience and Advantage licensing, for example, was associated with reduced availability of loans and increased concentration of finance companies.<sup>52</sup> They were 50 percent more concentrated where entry was impeded, so the entry barriers could have explained the negative correlations between concentration and access. The NCCF recognized that concentration may have been a consequence, rather than a cause, of restrictions on competition, just as high interest rates and reduced availability of credit appeared to have been.<sup>53</sup> As the NCCF characterized the record:

There is ample evidence indicating that competition is impaired in a number of states by a variety of conditions affecting all of the major types of consumer credit. A common structural condition of these markets is that they tend to be highly concentrated and difficult for newcomers to enter because of relatively slow growth in demand for credit, or legal restrictions

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<sup>51</sup> Id. ([T]he burden of subsidy falls primarily on cash buyers, some of whom may have been unable to obtain credit. Thus state laws that put the price of credit below competitive rates are forcing both the wealthy and the less affluent, who do not use or cannot obtain credit, to subsidize the use of credit by others.”)

<sup>52</sup> Id. at 130-31.

<sup>53</sup> See, e.g. Id. at 136.

on entry, or some other impediment or combination thereof. By comparison many other state markets appear to be fairly competitive, a judgment which is indicated not only by the existence of contrasting structural conditions but also by related measures of better performance.<sup>54</sup>

Consumers suffered costly consequences in states that protected financial institutions from competition. Different ceilings for different lenders created market segments that allowed a few firms to dominate without fear of encroachment from other segments. For example, commercial banks in New York were confined to a maximum rate of 11.6 percent, which prevented their entry into “the \$500 loan market served by consumer finance companies at 24.8 percent.”<sup>55</sup> The NCCF noted that borrowers “would have been significantly better off if banks had always been able to charge the same rates permitted licensed lenders.” The significance is apparent from a conversion of the principal and interest on the \$500 loan into current dollars. Inflation since 1970 has turned the purchasing power of \$500 into \$3,400 today.<sup>56</sup> Expressed in 2020 dollars, the difference in interest rates (24.8 instead of 11.6) could have cost borrowers as much as an extra \$260 in interest payments on a one-year loan.<sup>57</sup> The disparity would have been greater for loans of longer maturities and for borrowers who would have qualified for lower rates at the banks. It would have been less for borrowers who got better deals at finance companies and those who would not have qualified for the better bank rates.

Banks, for their part, enjoyed protection from finance companies. For example, reported the NCCF, “licensed lenders in New York may lend no more than \$1,400 to any one borrower, whereas banks may make consumer loans as high as \$5,000.” Banks could make loans between those amounts without worrying about competition from finance companies. The segmentation created by these restrictions that separated classes of credit grantors, the NCCF said, was “blatantly anticompetitive.”<sup>58</sup>

The consumers who suffered the most serious may harm may not have been those who paid the higher rates. Where rate caps were low and entry restrictions high, lenders rationed loans and turned away applicants. By the NCCF’s measure, in states with both types of restrictions, people took out fewer loans and smaller loans – about two-thirds as much overall—while rejection rates

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<sup>54</sup> Id. at 136

<sup>55</sup> Id. at 238.

<sup>56</sup> Inflation conversion from Saving.org, available at <https://www.saving.org/inflation/>.

<sup>57</sup> At 24.8 percent, interest payments would have added up to \$475 instead of \$215 for the lower rate. A precise comparison would take into account the added expenses of administering smaller loans and poorer credit records of finance-company customers, but it is difficult to dismiss the conclusion that they paid a great deal for the restrictions placed on banks. Interest calculations from Saving.org, at <https://www.saving.org/calculators/loan-calculator>.

<sup>58</sup> NCCF (1972), *supra* note 5, at 94.

were almost half again as high as those in states with easier entry.<sup>59</sup> Applicants had little more than a 50-50 chance to get a loan in states that regulated rates and entry. The odds were 2:1 in consumers' favor in less restrictive states. Where entry was restricted but rate ceilings were relaxed, rejection rates for credit applicants still rose and the average size and number of loans still lagged, but not by as much. Adverse consequences of entry barriers thus occurred in states regardless of rate ceilings; only the extent of the damage differed.<sup>60</sup>

Regulations limiting entry and access were not, however, the only source of competitive impairment in the credit sector, the NCCF believed. It was concerned with private threats to competition as well. Accordingly, the Report called for vigorous antitrust enforcement against restraints of trade, and it identified practices that should be investigated:

Although almost obvious, the Commission recommends that antitrust policy, both federal and state, be alert to restrictive arrangements in the credit industry. Any hint of agreement among lenders as to rates, discounts, territorial allocations, and the like must be vigorously pursued and eliminated.<sup>61</sup>

The Antitrust Division of the Department of Justice and the Federal Trade Commission (FTC) have challenged and eliminated many agreements among competitors that could have restricted competition. But many such agreements are beyond their reach. Some of the “blatantly anticompetitive” restrictions that the NCCF identified are also the most enduring, because the antitrust are laws typically exempt from prosecution restraints that governments authorize. Against such restraints, advocacy for competition and consumers remains the primary approach for antitrust enforcers, and the combination of enforcement and advocacy has been effective at “eliminating anticompetitive barriers to competition...and providing consumers with the information they need to take advantage of a competitive marketplace.”<sup>62</sup>

Restricted competition can be beneficial for financial institutions, the NCCF recognized, because market power meant stability and profitability of the insulated incumbents. Stability and profitability appealed to financial authorities as well, but the NCCF criticized regulators over

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<sup>59</sup> NCCF (1972), *supra* note 5, at 131.

<sup>60</sup> NCCF (1972), *supra* note 5, at 132.

<sup>61</sup> NCCF (1972), *supra* note 5, at 138

<sup>62</sup> United States, THE INTERFACE BETWEEN COMPETITION AND CONSUMER POLICIES, Contribution to the Global Forum on Competition, OECD (2008) The Antitrust Division of the Justice Department and the Federal Trade Commission explained: “Because the “state action doctrine” in United States law protects state laws from antitrust challenge in most cases, the FTC and DOJ have focused their efforts on competition advocacy [arguing] that consumers are better protected when they can choose between high cost/high service and low cost/low service providers rather than requiring them to pay for services they may not want or need.” Available at <http://www.oecd.org/unitedstates/39915760.pdf>.



“excessive concern...for the protection of the profitability of existing bank institutions” and disagreed that the restraints served the “needs and convenience” of the public.”<sup>63</sup> In the judgment of the NCCF, allowing “domination by relatively few firms” of affected markets was not worth the costs.

The NCCF could have framed its conclusion more directly in terms of effects on consumers. When regulators allow the welfare of the banks to outweigh the interests of consumers, those who are supposed to benefit from oversight instead pay its costs.<sup>64</sup> For consumers who could get credit despite unfavorable conditions, the costs were higher rates and smaller loans. For consumers who could not, the costs came in the form of doing without the goods or services, or intergenerational accumulation of wealth that credit would have made available. The most desperate consumers, not infrequently consumers who faced discrimination in an unregulated market, found a third way: doing business with illegal lenders. It was well known in the decades the NCCF studied that “consumer lending was a standard business activity of criminal organizations operating in many major metropolitan areas across the United States.”<sup>65</sup> Restricting legitimate competition sometimes simply sends it to the underworld, where consumer protection depends on the rules and remedies of juice loans and enforcers.

Numerous findings from the NCCF’s assessment of competition bear on the potential for discriminatory practices by lenders. Already noted was the analysis of access in the Report, which found that restrictions on competition frequently reduced the availability of credit, leading to rationing that presumably excluded borrowers of lesser means and lower credit scores. In the data, the NCCF looked specifically for indications of gender discrimination and found widespread evidence of it.<sup>66</sup> The NCCF also conducted some research on racial discrimination but the evidence it collected was too limited to draw reliable conclusions.<sup>67</sup> Elsewhere this Report (see Chapter 10) considers more recent information on discrimination. Later this chapter considers competition and access in modern credit markets.

To improve competition the NCCF proposed a menu of policy changes that would expand consumers’ choices and advocated regulations that could improve the wisdom of those

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<sup>63</sup> NCCF (1972), *supra* note 5, at 137.

<sup>64</sup> *Id.*

<sup>65</sup> Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd Zywicki, Consumer Credit and the American Economy 362 (2014).

<sup>66</sup> NCCF (1972), *supra* note 5, at 160 (For a review of the role women played a prominent role in consumer credit markets from medieval times to the nineteenth century, see the Appendix.)

<sup>67</sup> NCCF (1972), *supra* note 5, at 153-55.\_\_\_\_\_

choices.<sup>68</sup> To implement its recommendations, the NCCF recommended that legislators, regulators, and enforcers strive to design and implement a sound competition policy for consumer credit. The goals of that policy should be these:

Promoting and maintaining competition among numerous sources of credit. Competition is the key ingredient “of a finance industry capable of providing an adequate supply of credit at reasonable rates”

Assuring “access *by all* to these alternate sources”

Preventing “excesses which the ‘system’ may invoke against the borrower.”<sup>69</sup>

Among all the available means to improve competition, the NCCF concluded that enhancing the ability of potential competitors to enter credit markets would be the most effective policy. In his communication to the President and Congress, the Commission Chairman explained:

As to our conclusion that free and fair competition is the ultimate and most effective protector of consumers, we have recommended the elimination of restrictive barriers to entry in consumer credit markets by permitting all creditors open access to all areas of consumer credit. We have urged the entry of savings and loan associations and mutual savings banks into the consumer credit market. We have recommended prohibitions on acquisitions that would eliminate potential competition or that would substantially increase concentration in state or local credit markets. We have also urged that rate ceilings which constrain the development of workably competitive markets be reviewed by those states seeking to increase credit availability at reasonable rates.<sup>70</sup>

Thus, the critical prescription for competition was to preserve the competitive dynamic that had characterized well-functioning credit markets in the postwar period. The NCCF recognized that this recommendation would not address all problems in credit markets, including access by marginalized groups. Markets that were open to entry and free of constraints that prevented companies from challenging one another were perceived to be the most likely to remain competitive and protect consumers.

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<sup>68</sup> NCCF (1972), *supra* note 5, at 214, See, e.g Ch. 10.

<sup>69</sup> NCCF (1972), *supra* note 5, at 2 (emphasis in original).

<sup>70</sup> NCCF (1972), *supra* note 5, at iii.

## 8.2 Competition in Credit, 1970 - 2020

The NCCF devoted a chapter of its Report to predictions on the future of consumer credit. Not surprisingly, many of those predictions failed to capture the nature and size of the markets in which credit is exchanged today. For example, the NCCF anticipated, “with a slowdown in the rate of increase in consumer credit and with fewer additions to the types of goods and services financed, credit grantors in the future are relatively more likely to rely on price competition than on nonprice competition.”<sup>71</sup>

Fortunately for consumers, the future exceeded expectations. Price competition continued to reduce costs of credit, but the most remarkable developments in competition came from new products and services. Among the aspects of nonprice competition that the NCCF did not predict was the rise of automated teller machines (ATMs), although the first one had made its appearance in the US in 1969 (two years earlier in the UK).<sup>72</sup> Nor did the NCCF foresee banking by computers and smart phones, still far in the future. For virtually every consumer in 1970, withdrawing cash meant going to the bank, obtaining a loan meant visiting a lender, and getting competing quotes meant visiting several sources—advertising might help start a search but narrowing options on the internet was unheard of. The NCCF did predict the growing use of bank-issued credit cards and the value they would deliver to an increasingly mobile population. It did not fathom the extent of the growth, or the effect that growth would have on the competition for consumer credit. Inconceivable at the time was a vast market for consumer finance that involved no visit to any location or meeting with any individual.

As for overall growth, the figures in Table 2-1 and 2-2 of Chapter 2 reveal that consumer credit outstanding has increased *thirtyfold* since the Commission’s Report.<sup>73</sup> Most of that growth has come from financial services and technologies that were nonexistent or insignificant in 1970. And a good portion of that growth reflects more consumers participating, both absolutely and proportionately, in legal credit markets today than in 1972.

The structure of the consumer finance sector appears to have changed significantly in the 50 years since the NCCF’s Report. At first glance, the traditional sources of credit show consolidation:

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<sup>71</sup> NCCF (1972), *supra* note 5, at 203

<sup>72</sup> Linda Rodriguez McRobbie, The ATM is Dead. Long Live the ATM!, Smithsonian Magazine, January 8, 2015, <https://www.smithsonianmag.com/history/atm-dead-long-live-atm-180953838/>.

<sup>73</sup> To be precise, the Commission predicted that the *rate* of the growth of credit would decline after 1970, and that turned out to be correct. The amount of credit outstanding was so small in 1940 that the \$100 billion increase through 1970 represented a slightly higher annual rate than the \$4 trillion increase since 1970.

The number of FDIC-insured banks dropped from more than 13,000 to fewer than 5,000 in 2018.<sup>74</sup>

Federally Insured Credit Unions numbered about 5,200 in the final quarter of 2019<sup>75</sup> The Commission had tallied more than 23,000 in 1972.

Finance companies, which the Commission in 1972 estimated at 3,700, have no authoritative census today but may have doubled to around 7,800.<sup>76</sup>

Dollar volumes and shares of consumer credit from Table 2-1 in Chapter 2 of this Report allow for comparisons of the major sectors around the time of the NCCF's Report to those today. Table 8-1 highlights the institutional types then and now:

**TABLE 8-1: CONSUMER CREDIT BY TYPE OF HOLDER**

	<b>1975 Billions</b>	<b>1975 Percent</b>	<b>2019 Billions</b>	<b>2019 Percent</b>	<b>2019 Excluding Government</b>
Depository Institutions	\$116	56.0%	\$1,771	42.3%	61.7%
Finance companies	\$33	15.9%	\$537	12.8%	18.7%
Credit unions	\$26	12.6%	\$482	11.5%	16.8%
Nonfinancial business	\$33	15.9%	\$40	1.0%	1.4%
Pools of securitized assets		0.5%	\$14	0.3%	0.5%
Federal government		0.0%	\$1,319	31.5%	-----

<sup>74</sup> *Annual Historical Bank Data*, FDIC available at [https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew\\_Char&selectedEndDate=2018&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc](https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew_Char&selectedEndDate=2018&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc)

<sup>75</sup> *NCUA Quarterly Reports*, available at <https://www.ncua.gov/newsroom/press-release/2020/ncua-q1-2020-state-credit-union-data-report-now-available> (In the eight years from December 2011 and December 2019, 1,800 credit unions exited the business.) CUNA estimated about 5,500 at the end of 2019, down from 11,000 in 1999. See *Monthly Credit Union Estimates*, June 2020. [https://www.cuna.org/uploadedFiles/Global/About\\_Credit\\_Unions/CUMonthEst\\_Jun20.pdf](https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_Jun20.pdf).

<sup>76</sup> One investors' service reported 7,800, see *United States Finance Companies*, CRUNCHBASE <https://www.crunchbase.com/hub/united-states-finance-companies>. The industry trade association has 440 members, see *AFSA Membership*, AMERICAN FINANCIAL SERVICES ASSOCIATION, available at <https://afsaonline.org/about-afsa/afsa-membership/>.

	<b>1975 Billions</b>	<b>1975 Percent</b>	<b>2019 Billions</b>	<b>2019 Percent</b>	<b>2019 Excluding Government</b>
Nonprofit and ed. inst.		0.0%	\$28	0.7%	1%
	\$207	100%	\$4,191	100%	100%

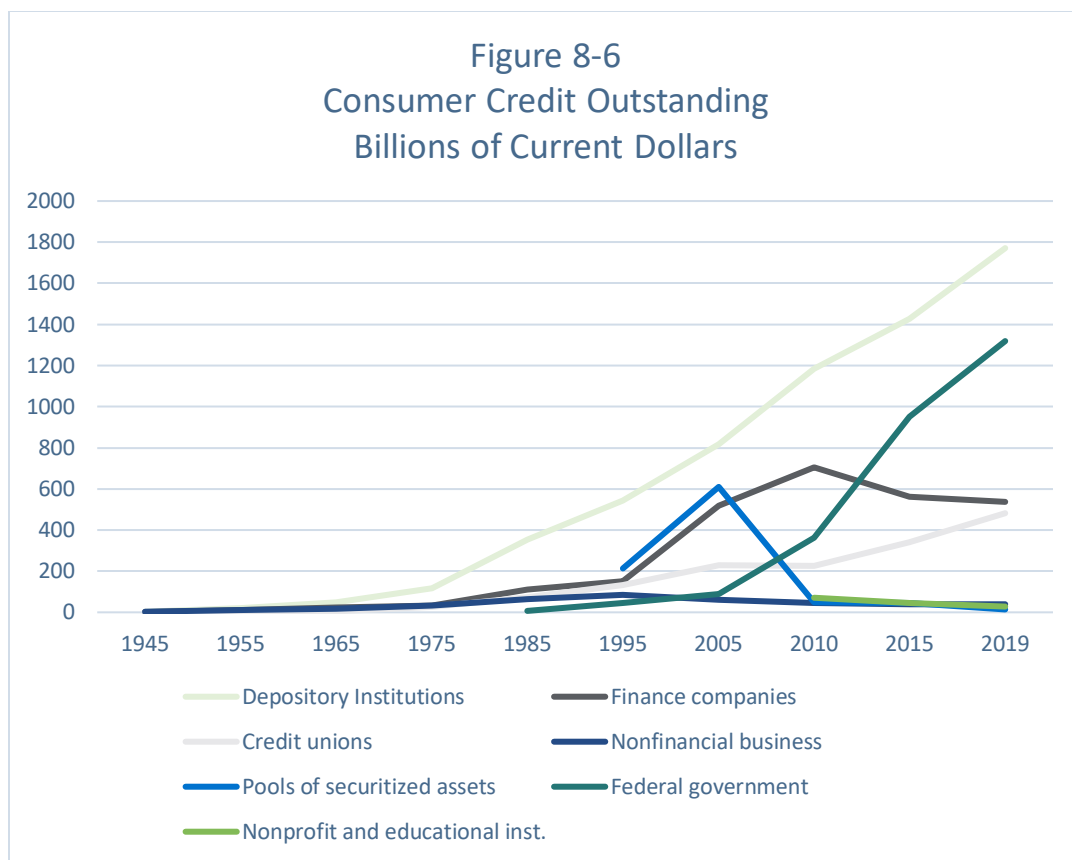
The table reveals an apparent drop in the shares of major types of institutions. For depository institutions (banks, savings, etc.) holdings dropped from 56 percent in 1975 to 41 percent in 2019 (close to their share in 1972). Finance companies and credit unions also lost share over the period, although their declines since 1975 appeared to be more modest. The share loss of nonfinancial businesses accelerated, dropping from about 16 percent to little more than a single point in 2019.

Declining shares of the top three sources should be viewed in light of the increase in consumer credit overall and the emergence of the federal government as a major holder. As shown in the final column of Table 8.1, it was the growth of government-held student loans that reduced the shares of the other sources despite the dramatic growth of the private sector. The federal government did not hold enough credit to warrant tracking at the time of the NCCF's Report, and its share still rounded to zero in 1975. Today, the government is the second largest creditor of consumers, after depository institutions. If its holdings were subtracted from the table, the shares of the traditional institutions would all increase by half. Banks (and savings institutions) would rise to around 60 percent, while finance companies and credit unions would approach 20 percent apiece, all above their shares in the early 1970s.

Expanding aggregate credit has translated into increased holdings for each of the major sectors since 1975. Even nonfinancial institutions, with one-tenth of their 1975 share, hold more dollars of consumer credit than they did 45 years ago (although adjusting for inflation would show a decline). Finance companies and credit unions have reached about half a trillion dollars, while depository institutions are well above a trillion.

Although less severe than the wide shifts in the first half of the century, the variations apparent in the chart continue to suggest inter-sector competition. Some sources of credit have nearly vanished. For example, pools of securitized assets rose from miniscule levels and fell back just as quickly in less than two decades. Banks and credit unions continued their long rise. The latter are now closing in on finance companies, whose shares have fallen over the last 10 years. Figure 8-6 shows these trends.

**FIGURE 8-6:** CONSUMER CREDIT OUTSTANDING BILLIONS OF CURRENT DOLLARS



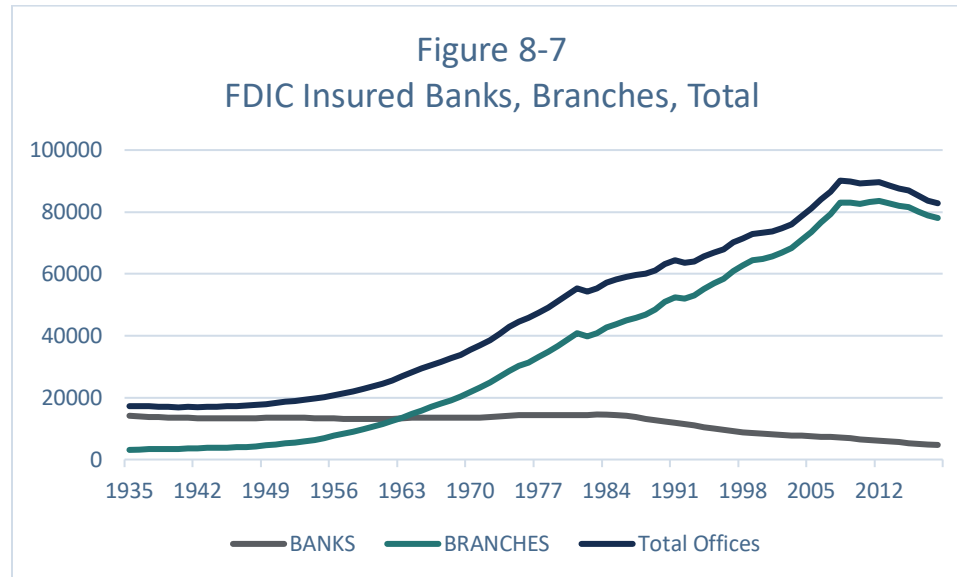
A closer examination reveals forces that have reshaped each sector, and how competition has evolved. Institutions have entered, exited, repositioned, and fought within and across sector borders

## 8.2.1 Banks

Growing aggregate shares combined with stable or declining numbers of institutions imply that concentration in consumer credit has increased above the levels that the NCCF observed. It is a matter of simple arithmetic. Fewer institutions will account for higher percentages of the whole. Beneath the aggregates, however, is a different picture. While the number of banks did drop by half, the number of branches tripled, from about 25,000 in 1972 to 78,000 today, putting the number of total offices above 80,000. Although the count of total bank offices has declined

slightly from its peak of about 90,000 in 2008, the proliferation of outlets remains near historic highs. Figure 8-7 illustrates the trends.<sup>77</sup>

**FIGURE 8-7:** FDIC INSURED BANKS, BRANCHES, TOTAL



Overall, the trends show that headquarters of financial institutions have declined while total storefronts have expanded, and for consumers, the storefronts matter. Like gas stations and grocery stores, local offices vie for the consumer's business.

Competition in the banking sector is monitored by both the Department of Justice and the Federal Reserve, which share responsibility for reviewing potential competitive effects of bank mergers.<sup>78</sup> To facilitate that effort the Fed collects and publishes structural data on banks and thrifts in markets across the United States. Concentration is measured by an index, called the Herfindahl-Hirschman Index, or HHI, which can range from near zero for a market with thousands of small competitors to 10,000 for a market dominated by one company. The Fed gives close scrutiny to mergers that would significantly increase the index in any market to levels

<sup>77</sup> *Annual Historical Bank Data*, FDIC available at [https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew\\_Char&selectedEndDate=2018&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc](https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew_Char&selectedEndDate=2018&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc). The same source shows the number of federally insured S&L's declining from over 3,500 to less than 700 between 1984 and 2018.

<sup>78</sup> For a description of the reviews, See DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION, *HORIZONTAL MERGER GUIDELINES*, (2010), available at <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010>, for a description of the criteria used in evaluating mergers, and DEPARTMENT OF JUSTICE, *Bank Merger Competitive Review -- Introduction and Overview* (1995) (currently under review), available at <https://www.justice.gov/opa/pr/antitrust-division-seeks-public-comments-updating-bank-merger-review-analysis>

of 1,800 or higher.<sup>79</sup> Mergers that do not move concentration above the threshold and small mergers above it, but which do not significantly change concentration, typically do not raise concerns. Consumers have plenty of options at HHI levels around 2,000.

A few examples of larger and smaller markets illustrate the conditions at different points on the HHI scale. The market that includes Houston, Texas has an HHI near 2,300, indicating concentration above the threshold of scrutiny. Yet the market has 92 commercial banks, which suggests that customers have a plethora of choices. It is because the top four banks have around 70 percent of total deposits that the HHI is relatively high. Columbus, Ohio has a level around 2,100, reflecting 48 banks and nine thrifts.<sup>80</sup> In Fargo, North Dakota, where the level is just under 1,800, customers can choose from 34 banks. El Paso, Texas, with a similar HHI, hosts 14 banks.

Larger markets can accommodate more banks and tend to generate lower scores. The New York City market, for example, with an HHI of 1300, contains 170 banks and 45 thrifts. Chicago, where customers can find 135 banks and 24 thrifts, has an HHI around 950. Even in small metropolitan areas, however, concentration typically remains below 2,000 on the HHI scale. Figure 8-8 tracks average indexes by size of SMSAs, from the smallest areas to the largest in the Fed's database from 1999 to 2019. Concentration, although rising, remains below 2,000 for banks and thrifts in most markets.

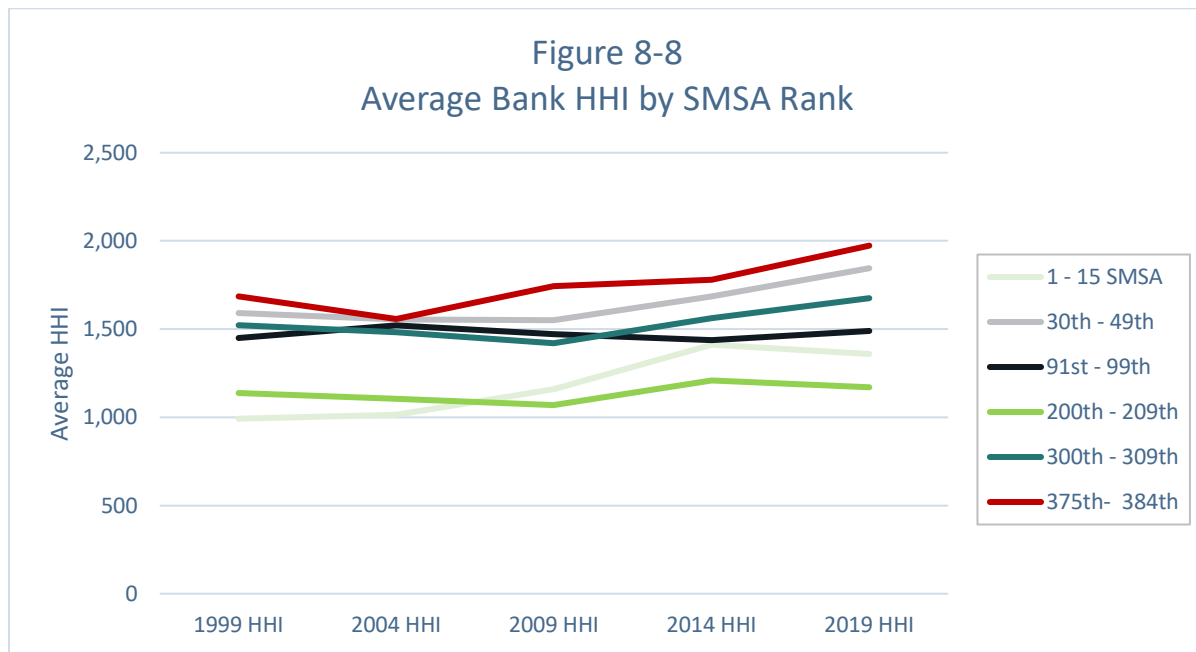
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<sup>79</sup> The Herfindahl Hirschman Index (or HHI), which is the sum of the squares of the percentage shares of the companies in a market. For example, ten companies, each with a share of 10 percent, would result in an HHI of 1,000. The square of 10 is 100, and 100 added ten times equals 1,000. A market comprising five firms of equal size yields an HHI of 2,000 (20 squared x 5). Branches are aggregated by institution, not counted individually. See, e.g., *Competitive Analysis and Structure Source Instrument for Depository Institutions*, ST. LOUIS FED, available at <https://Cassidi.Stlouisfed.Org/Index>.

<sup>80</sup> Thrift institutions are discounted by 50% in HHI calculations, in light of their more limited services compared to banks. See How do the Federal Reserve and the US Department of Justice, Antitrust Division, analyze the Competitive of mergers and acquisitions under the Bank Holding Company Act, the Bank Merger Act, and the Home Owners' Loan Act; FAQs, BOARD OF GOVERNORS OF THE FEDERAL RESERVE BOARD, available at <https://www.justice.gov/sites/default/files/atr/legacy/2014/10/09/308893.pdf>



**FIGURE 8-8:** AVERAGE BANK HHI BY SMSA RANK



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Some indications of the future of competition in banking may be evident from the trends in concentration. In both the larger and smaller markets, concentration was relatively stable between 1999 and 2009, but then rose noticeably in the five years between 2009 and 2014. Over the last five years the rise reversed in some of the largest markets but has continued in smaller population centers.

Within the largest metropolitan markets, the trends in consolidation are unlikely by themselves to suggest potential anticompetitive effects. Banking in big cities has become more concentrated but not to the point that raises risks that competition may be suffering. On the other hand, the smaller markets have reached levels that suggest further consolidation could face resistance from competition authorities—if that consolidation occurs by merger. There is little the

<sup>81</sup> Source: FDIC's Summary of Deposits, Market Share Reports, available at <https://www7.fdic.gov/sod/sodMarketBank.asp?barItem=2>.

1-15 Avg Population 7,240,113

32-49 Avg Population 1,591,927

90-99 Avg Population 622,387

200-210 Avg Population 224,861

300-310 Avg Population 134,483

376-384 Avg Population 67,358

authorities can do to prevent concentration from increasing by attrition, for example when a bank simply exits a market. Both consolidation and attrition are occurring in small markets.

An insight into how the changes in concentration can affect the consumer market was described in a 2015 study on community banks.<sup>82</sup> The authors cited Bureau research that had found community banks “can be a lifeline to hardworking families paying for education, unexpected medical bills, and homes.”<sup>83</sup> Business pressure, however, was causing these banks to pull back from consumer lending and focus on commercial loans to local companies. Small banks, research has found, have a comparative advantage over large institutions by virtue of the closer customer relationships that the local setting allows. Despite the advantage, the prospects for those banks remain in doubt as well. A chart from the study depicts a shift in lending to individuals from 2010 to 2014; reproduced as Figure 8-9, the chart shows community banks’ lending declining, with the smallest banks’ loans declining the most:<sup>84</sup>

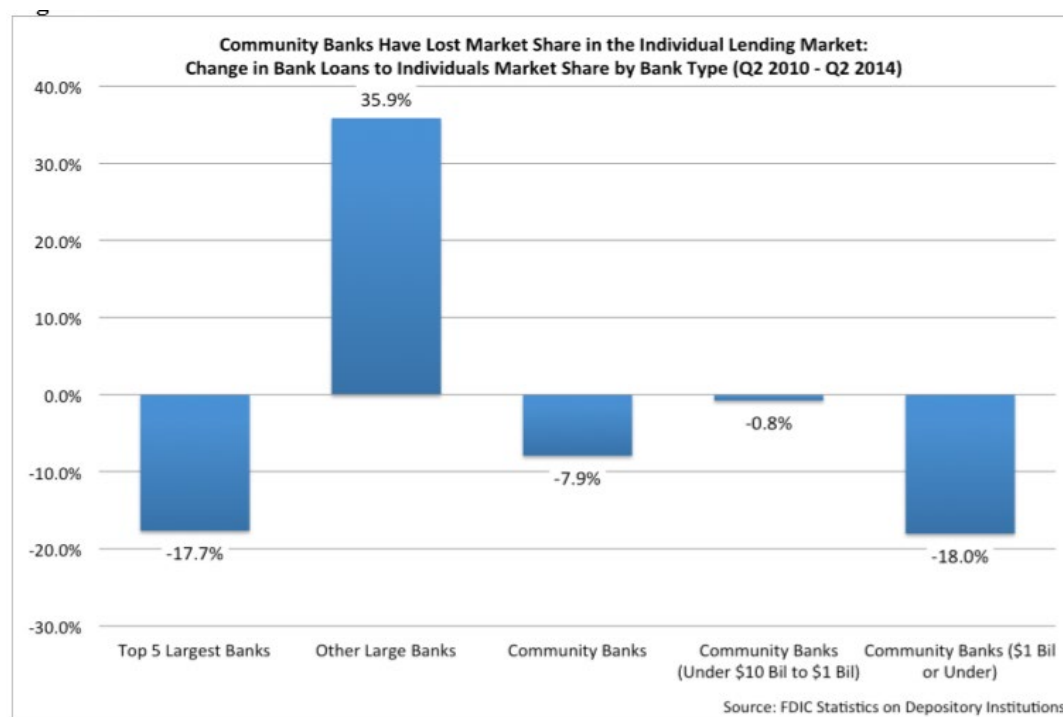
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<sup>82</sup> Marshall Lux, *The State and Fate of Community Banking February 9, 2015*, M-RCBG ASSOCIATE WORKING PAPER SERIES, No. 37 (2015) available at [https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final\\_State\\_and\\_Fate\\_Lux\\_Greene.pdf](https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf)

<sup>83</sup> Id. (CITING CONSUMER FINANCIAL PROTECTION BUREAU, COMMUNITY BANKS AND CREDIT UNIONS, <http://www.consumerfinance.gov/small-financial-services-providers/> (accessed January 10, 2015))

<sup>84</sup> Id., Figure 12, at 19.

**FIGURE 8-9:** COMMUNITY BANKS HAVE LOST MARKET SHARE IN THE INDIVIDUAL LENDING MARKET: CHANGE IN BANK LOANS TO INDIVIDUALS MARKET SHARE BY BANK TYPE (Q2 2010 – Q2 2014)



The Chairman of the FDIC described the disconcerting trend:

Small banks like these are slowly disappearing from America’s landscape. Today, 627 counties are only served by community banking offices, 122 counties have only one banking office, and 33 counties have no banking offices at all.<sup>85</sup>

It bears repeating that market structure is merely the beginning of a competition analysis. Factors other than concentration can elevate or alleviate initial concerns that the measure of firms in a market may raise. In sectors where competitors can increase capacity quickly, as is the case in consumer credit, concentration exaggerates the significance of large firms and underestimates the importance of small firms. Dominant lenders cannot raise rates and count on small competitors to empty their inventory of loans. Another ambiguity in bank indexes stems from their units of measurement. In the Fed statistics, HHIs are based on total deposits, which are at best loosely correlated with the various financial services that banks and thrifts

<sup>85</sup> Jelena McWilliams, *BankThink/We can do better on de novos*, AMERICAN BANKER, December 06, 2018, <https://www.americanbanker.com/opinion/fdic-chairman-jelena-mcwilliams-we-can-do-better-on-de-novos>. The NCCF voiced similar concerns when it recommended research to examine “the adequacy of competition in isolated communities – so called “one-bank” towns – to determine whether residents in those areas obtain adequate amounts of consumer credit at reasonable prices.” NCCF, *supra* note 5 at 166.

provide.<sup>86</sup> Because banks can readily reallocate funds from one investment to another—for example, from business finance to consumer credit or from mortgages to auto loans—their ability to compete for consumers is not tied tightly to their total assets. As described in Appendix B, banks facing diminished commercial demand during the Great Depression opened new consumer credit departments, emulating smaller finance companies that were expanding their own operations. These dynamic factors mean that concentration measures do not fully capture the competitive threat that small rivals or small operations present to established institutions. The structure of a market at any given moment provides a helpful context to an assessment of competition, but concentration alone is insufficient to support conclusions about competition.

After identifying the contours of a market and the participants in it, a competition analysis typically turns to the conditions of entry. Consolidation, decline, and even the exit of firms from a market may have little impact on competition if new companies can fill the voids left by companies that decline or depart. As described in Appendix B, finance companies opened offices a century ago while authorities were closing others. Mutual savings banks, which were slow to innovate and declined as a result, offer another example.<sup>87</sup> Competitive analysis must therefore consider conditions of entry, as it is a powerful antidote to anticompetitive performance and unsatisfied demand.

Here the evidence is disconcerting for the banking sector. As is apparent in the trends of new charters for FDIC-insured banks, illustrated in Figure 8-5, entry of banks has dropped to the lowest levels in 80 years. After averaging over a hundred a year from 1960 to 2010 – often exceeding 200—roughly two charters a year have been issued in the United States since 2010. The phenomenon could be driven by diminished interest in entering the sector, higher costs of doing so, or a combination of both. It may be that an FDIC-insured charter is not as important an asset as it once was in the provision of financial services. If so, that could explain a declining demand for the charters. However, an alternative hypothesis is that insured banks remain an important component in the competitive environment, but that entry has become so costly that efficient providers have been discouraged from taking the opportunity. The most recent data suggest a slight rise in new banks applying for FDIC insurance the past few years, with the annual openings averaging half a dozen in the 2017 to 2019. The trends did not encourage the

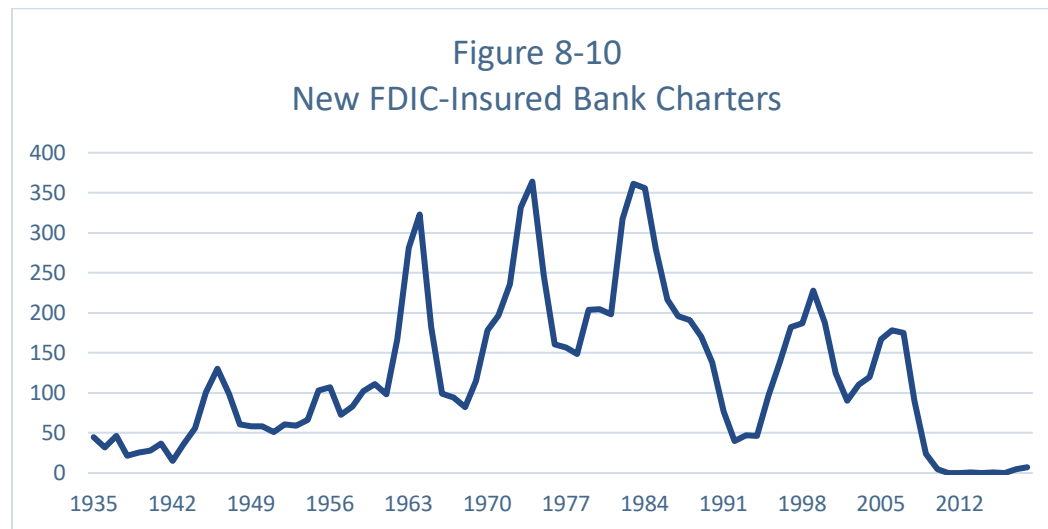
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<sup>86</sup> A Fed study noted that “HHI is a measure of concentration for the base good, a bank account measured by deposits, and less of a measure of competition for the aftermarkets. Since most bank fees stem from aftermarket good purchases, the standard relationship between concentration and...fees need not apply.” See Robert M. Adams, *Bank Fees, Aftermarkets, and Consumer Behavior*, FINANCE AND ECONOMICS DISCUSSION SERIES (2017), available at <https://www.federalreserve.gov/econres/feds/files/2017054pap.pdf>.

<sup>87</sup> 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>

Chairman of the FDIC who observed that “never before has the level of new banks been so low for so long—only two new startup banks opened between the end of 2010 and the end of 2016, and just 11 have opened since the end of 2009, most in the past 18 months.”<sup>88</sup>

**FIGURE 8-10:** NEW FDIC-INSURED BANK CHARTERS



One more charter could have changed the concentration of depositories dramatically. Walmart has struggled, without success, to enter the sector for years. In the 1990s, it tried to become a thrift holding company, which would have allowed it to open in thousands of American stores. The Bank Holding Company Act restricted companies engaged in nonbank businesses from owning banking subsidiaries, but the option for Walmart to own a subsidiary operating a thrift had a venerable precedent; it was the model that Ford Motor Company, Household International (previously Household Finance Company), and Sears, Roebuck had used to offer financial services to their customers. Before Walmart could execute the plan, Congress passed the Gramm-Leach-Bliley Act of 1999, blocking the move.

A decade later, Walmart tried again, taking advantage of another innovation from the early 20th century. It obtained a charter to operate an industrial loan company (or ILC, like the institutions that once focused on blue-collar customers). Those charters allowed a commercial entity to own a financial institution that could take deposits and make loans. This time the FDIC blocked the move by denying Walmart deposit insurance, the application for which was “fiercely opposed”

<sup>88</sup> McWilliams (2019), *supra* note 85.

by bank lobbies.<sup>89</sup> At public hearings before the FDIC, the American Bankers Association (ABA) complained, “Walmart has begun testing full-service Walmart money centers for using stored-value cards, debit cards and ATMs. It is also rolling out its Money Center Express machines, which will permit customers to use credit or debit cards in a wide variety of ways.”<sup>90</sup>

The competition that the ABA opposed did not materialize. The FDIC imposed a moratorium on all ILC applications for deposit insurance in 2006. Walmart withdrew its application in 2007. Any prospect of reconsideration, for Walmart or another company like it, was suspended in 2010, when the Dodd-Frank Act imposed a three-year moratorium on deposit insurance for any new industrial loan company. The moratoriums are typically justified as measures to assess and improve safety and soundness, but there is little evidence that ILCs present more risk than commercial banks, and little dispute that competitor protection plays a role.<sup>91</sup> As the Congressional Research Service put it:

Certain observers, including community banks, have concerns over whether purely commercial or purely banking organizations would be able to compete with combined organizations that could potentially use economies of scale and funding advantages to exercise market power.<sup>92</sup>

With about 4,000 stores, many of which serve customers who are more likely to be unbanked or underbanked, located in communities where banks are more likely to be scarce, Walmart could have introduced financial access to millions and competition to millions more, but it was not able to surmount the barriers to entry that banks had persuaded regulators to build around their business. Despite the setback, Walmart does offer a limited variety of financial services, including smart phone checking with affiliated institutions, but as of 2014, the stores do not present the bundle of services available at a typical bank or thrift. Consumer Reports compared Walmart’s limited services to those offered by a bank and rated the bank superior.<sup>93</sup>

Academic research described below finds that branch banks bring valuable benefits to underserved areas and populations. These are the services that entry barriers are denying

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<sup>89</sup> See, Lawrence J. White, *Walmart and Banking: It's Time to Reconsider*,” MONEY AND BANKING (May 15, 2017), available at <https://www.moneyandbanking.com/commentary/2017/5/13/walmart-and-banking-its-time-to-reconsider>.

<sup>90</sup> *Banks fight Wal-Mart's application for bank charter*, ATM MARKETPLACE, (April 20, 2006) <https://www.atmmarketplace.com/news/banks-fight-wal-marts-application-for-bank-charter/>.

<sup>91</sup> See, E.g., Barth, James R. & Sun, Yanfei, 2020. "Industrial banks: Challenging the traditional separation of commerce and banking," *The Quarterly Review of Economics and Finance*, Elsevier, vol. 77(C), pages 22

<sup>92</sup> Congressional Research Service, “Banking Policy Issues in the 116th Congress” February 21, 2019, <https://fas.org/sgp/crs/misc/R45518.pdf>.

<sup>93</sup> *Should Walmart be your next bank?* CONSUMER REPORTS (2014) <https://www.consumerreports.org/cro/magazine/2014/11/should-walmart-be-your-bank/index.htm>.

consumers in underserved areas. Lower costs and broader services that competition from Walmart could have brought to consumers were lost when incumbents complained.

Resistance to new entry has not abated. After the FDIC recently approved deposit insurance applications for a payment company and a student loan servicer, bank associations and advocacy groups petitioned Congress to reinstate the Dodd-Frank Act's three-year moratorium on ILC charters. The threat they cited was not the brick and mortar that Walmart had brought to rural counties, but technology that is becoming available everywhere: "In the era of dominant Big Tech, we should be cautious before giving technology companies even greater reach into the economic life of Americans by allowing them to own banks."<sup>94</sup> As ever, entry, the dynamic process that has driven much of the competition in the financial sector, is in jeopardy.

Better data, more sophisticated statistical techniques, and improvements in economic analysis enable more direct assessments than the NCCF could make of the intensity of competition. The banking sector is especially amenable to analyses that go beyond inferences drawn from differences in concentration across states. Numerous studies of bank competition have been published in recent years, the results of which indicate a business where competition has been keen. Reviewing the literature in 1994, Shaffer found that most U.S. banking markets "behave quite competitively at the bank-wide level, even where highly concentrated," although there may be some exceptions in some individual product lines, such as consumer deposit accounts.<sup>95</sup>

In a recent study that tracked the performance of the banking sector from 1984 to 2016, Mendenhall found that its performance exceeded competitive equilibrium levels.<sup>96</sup> He found output of the banks to be "supercompetitive," greater than that expected from competitive markets, and competition did not suffer from the trend of increasing concentration. To the contrary, the evidence pointed toward improving competition. For example, the spread between cost of funds and interest charged actually declined, from 3.3 percent at the beginning of the of the period studied to 2.9 percent at the end.

Most of the competition studies assess banks' overall business, which includes both commercial and consumer lines. Commercial customers are well equipped to impose competitive discipline; they can take their business anywhere in the country and to sources overseas. Whether

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<sup>94</sup> Letter from the Bank Policy Institute, Center for Responsible Lending, Independent Community Bankers of America, to the Honorable Mike Crapo, et al. (July 29, 2020)(The two companies were Square and Nelnet.).

<sup>95</sup> Sherill Shaffer, *Bank Competition in Concentrated Markets*, BUSINESS REVIEW (February 1994).

<sup>96</sup> Slade Mendenhall, *Commercial Bank Competition*, Riegle-Neal, and Dodd-Frank, SSRN (2017), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2967998](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2967998).

consumers realized the benefits of competition that these studies have found requires examination of the services they purchase in the market.

There is no question that consumer choices have expanded since the time of the NCCF's Report. Already mentioned are the branches, which grew by the tens of thousands, brought banking to underserved communities, and moved banks closer to consumers in larger markets. Beyond brick and mortar, innovation has provided a growing volume and variety of banking services. The ATM first appeared in 1969. Now ubiquitous, these outlets have grown to an estimated 470,000 in 2018.<sup>97</sup> Banks were the original owners and proprietors of ATMs. Today, fewer than half are bank machines; independent companies operate the remainder. Whether owned by the user's bank, another bank, or nonbank institution, ATMs connect consumers with their banks and many of the services their banks provide. Among the aspects that distinguish independent ATMs: They are more likely to locate in areas with higher unemployment, lower incomes, and lower housing values. Like the consumer lenders of a century ago, independent institutions have found a profit opportunity in bringing financial services to communities where banks are relatively rare.<sup>98</sup>

These developments were made possible by changes in the legal environment of consumer finance, and some of the changes track the recommendations in the NCCF's Report. Restrictions that the NCCF criticized have been amended, repealed or rendered obsolete. Antitrust enforcement has reduced anticompetitive practices. The developments are especially relevant to barriers between institutional segments, geographic markets, interest rate flexibility, loan availability, and lender and servicer performance.

The opening of geographic markets and the competition among institutions would have been impossible without legal reforms of the sort that the NCCF advocated. Pivotal events included a Supreme Court decision in 1978, *Marquette Nat. Bank v. First of Omaha Svc. Corp.*, which settled the question as to which state laws would apply to interstate banks; the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which lifted restrictions that states had imposed on banks crossing borders; and the Gramm-Leach-Bliley Act of 1999, which expanded the financial services that banks could offer.<sup>99</sup> The reduction of barriers unleashed the

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<sup>97</sup> Lian An, Christopher Baynard, Chiradip Chatterjee, Chung-Ping A Loh, *The Locational Study Of Atms In The U.S. By Ownership* (2018), available at [http://www.akleg.gov/basis/get\\_documents.asp?session=31&docid=22687](http://www.akleg.gov/basis/get_documents.asp?session=31&docid=22687)

<sup>98</sup> The higher transaction fees that independents charge have inspired efforts to cap them. *Id.*

<sup>99</sup> *Marquette Nat. Bank v. First of Omaha Svc. Corp.*, 439 U.S. 299, 99 S. Ct. 540; 58 L. Ed. 2d 534 (1978) (interpreting the National Bank Act of 1864); H.R.3841 - Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, 103rd Congress (1993-1994).



proliferation of branches described above, as banks quickly crossed the borders that previously had confined them.

A summary of the literature on barriers and their effect on competition in banking found that the spread of branches had been painful for some local banks, especially in rural areas, but beneficial for consumers.<sup>100</sup> Empirical analysis documented some of the effects on access to credit:

We first establish the positive effect of interstate branching deregulations on the density of bank branches in poor counties. We find that the density of bank branches increases by around 30% in poor counties after a state fully deregulates.

Second, we show that interstate branching deregulation is associated with a significant drop in the rate of unbanked households among low-income populations. [Illustrative is] the change in the likelihood of holding a bank account in the years before and after deregulation relative to a control group of states that do not deregulate. We observe a significant increase in the share of banked households following deregulation.<sup>101</sup>

Another study found similar effects. Branches that spread after banks were allowed to cross state lines reduced the percentage of unbanked populations in poor communities.<sup>102</sup> The effect was stronger for populations that were likely to be rationed by banks, “such as African American households in ‘high racial bias’ states, or for households living in rural areas where branch density is initially low.”

Legislation and regulations that increase costs or reduce opportunities can compound the challenges facing institutions on the margin of profitability. Considering pressure on banks and credit unions in smaller communities, the US Treasury identified potential effects:

Community financial institutions’ business models have come under pressure from a slow economic recovery and low interest-rate environment, additional competition (e.g., internet banks and nonbank lenders), and added compliance costs from new regulations. Together, such factors have contributed to a difficult operating environment and the ongoing consolidation of

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<sup>100</sup> Robert M. Adams and Dean F. Amel, *The Effects of Past Entry, Market Consolidation, and Expansion by Incumbents on the Probability of Entry*, FINANCE AND ECONOMICS DISCUSSION SERIES (2007), available at <https://www.federalreserve.gov/pubs/feds/2007/200751/200751pap.pdf>

<sup>101</sup> Bank Branch Supply and the Unbanked Phenomenon, available at [https://pdfs.semanticscholar.org/e9b6/f210629419b5ec6f53f8227448a29dae61f0.pdf?\\_ga=2.249876995.461538237.1596483228-41928408.1596483228](https://pdfs.semanticscholar.org/e9b6/f210629419b5ec6f53f8227448a29dae61f0.pdf?_ga=2.249876995.461538237.1596483228-41928408.1596483228)

<sup>102</sup> Claire Celerier and Adrien Matray, “Bank Branch Supply and the Unbanked Phenomenon,” Draft, October 17, 2016

smaller banks and credit unions....The impact of consolidation has been particularly profound on smaller banks, as the number of institutions with assets less than \$100 million declined by 85 percent between 1985 and 2013. Similarly, the total number of credit unions in the country has declined..., with the impact mostly concentrated among smaller credit unions. Feedback provided to Treasury suggests that the cumulative effects of regulatory requirements weigh heavily on community banks and credit unions.<sup>103</sup>

The concerns expressed by the Treasury are reflected in the findings of academic research. Lux summarized research that found bank consolidation increasing after regulatory and legislative changes made operations more costly.<sup>104</sup> Researchers were typically careful to note the difficulty of finding causal links between events and subsequent developments, but the number of studies finding correlations between different regulatory initiatives and changes in banking markets led the author to suggest that regulation was causing consolidation.

The Dodd-Frank Act was expected to raise compliance costs, and those costs could have disproportionately burdened small banks. A 2014 survey reported that more than a quarter of banks with less than \$10 billion in assets planned to hire new compliance or legal personnel, while more than a third of banks had already hired new staff to deal with new CFPB regulations.<sup>105</sup> A Minneapolis Fed study that year identified the personnel costs of complying with regulations at banks with less than \$50 million in assets. Lux described the findings and a Fed governor's reaction:

At these institutions, the study found that hiring two additional personnel reduces median profitability by 45 basis points, resulting in one-third of these banks becoming unprofitable. As Fed Gov. Tarullo has noted, "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets."<sup>106</sup>

Enough time has elapsed since the Dodd-Frank Act to observe more direct evidence of its effects on competition, allowing analysts to examine whether the governor's concerns were justified.

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<sup>103</sup> US TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES - BANKS AND CREDIT UNIONS, 56-57 (2017). Available at <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf> (footnotes omitted).

<sup>104</sup> Marshall Lux, *The State and Fate of Community Banking February 9, 2015*, M-RCBG ASSOCIATE WORKING PAPER SERIES, No. 37 (2015) available at [https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final\\_State\\_and\\_Fate\\_Lux\\_Greene.pdf](https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf).

<sup>105</sup> Hester Peirce, Ian Robinson & Thomas Stratmann, *How Are Small Banks Faring under Dodd-Frank?* WORKING PAPER 14-05, THE MERCATUS CENTER AT GEORGE MASON UNIVERSITY (February 2014).

<sup>106</sup> Daniel Tarullo, Speech at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014)).

Buchak, et al., attributed about 60 percent of the growth of nonbank mortgage lending to increased regulation that banks faced between 2007 and 2015.<sup>107</sup> Mendenhall examined the effects of two major reforms: the Riegle-Neal Act and the Dodd-Frank Act. For a measure of competition, Mendenhall used the spread between cost of funds to banks and interest charged to customers, and he found that the spread dropped (bank competition clearly increased) after Riegle-Neal had allowed interstate banking. The spread continued to shrink after the Dodd-Frank Act added regulatory costs, although the findings with respect to the latter were marginally significant.<sup>108</sup> The author noted that competition might have been even more robust in the last decade without the Dodd-Frank Act, but he could only surmise. Nonetheless, the most recent evidence indicates competition continues to constrain the rates that banks can charge.

Never far from the subject of competition in financial markets is the question whether competition is consistent with safety and soundness.<sup>109</sup> On one hand is the concern that competition will cause banks to make excessively risky loans; on the other is the hope that competition will better serve consumers.

Empirical research offers some insight. For example, one study found that “increased competition induces banks to become more specialized and efficient” but also induces banks to extend credit to riskier borrowers and suffer higher default rates. However, the author did not reach a definitive conclusion as to soundness. Her qualified conclusion was that the competition was “possibly creating a less stable financial system.”<sup>110</sup>

Another study found that in competitive mortgage markets, local banks lowered their lending standards by twice as much as those in concentrated markets, but the pressure did not appear to affect standards at national banks.<sup>111</sup> Implications about soundness were accordingly qualified.

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<sup>107</sup> Greg Buchak, Gregor Matvos, Tomasz Piskorski, Amit Seru, *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks* (March 2018) NBER Working Paper No. 23288, <https://www.gsb.stanford.edu/faculty-research/working-papers/fintech-regulatory-arbitrage-rise-shadow-bank>. (Regulation included capital requirements and litigation. Thirty percent of the growth was attributed to technology.) See also, Consumer Bankers Association, Comment Letter in Response to Request for Information to Assist the Taskforce on Federal Consumer Financial Law (June 1, 2020) <https://beta.regulations.gov/comment/CFPB-2020-0013-0089>, (playing field tilted against traditional banks).

<sup>108</sup> Mendenhall (2017), *supra* note 96.

<sup>109</sup> The debate was joined by Adam Smith in 1776. (See appendix.)

<sup>110</sup> Gissler, et al., *The Effects of Competition in Consumer Credit Markets*, WP 12-24, CONSUMER FINANCE INSTITUTE (2018), available at <https://doi.org/10.21799/frbp.wp.2018.24>.

<sup>111</sup> Xiaochen Feng, *Bank Competition, Risk Taking and their Consequences: Evidence from the U.S. Mortgage and Labor Markets*, IMF Working Papers (2018), available at <https://www.imf.org/en/Publications/WP/Issues/2018/07/06/Bank-Competition-Risk-Taking-and-their-Consequences-Evidence-from-the-U-S-46034>

A third study found that both national and local banks reacted to changes in competitive conditions.<sup>112</sup> Assessing the effect of the preemption of state regulations by the Office of the Comptroller of the Currency (OCC), the authors compared mortgage lending in formerly restrictive states with lending in states that had imposed more limited rules. After the lifting of restrictions, national banks increased originations of riskier loans—for example, with deferred amortization or interest-only payments. Local banks followed suit, but only in counties where OCC banks were more concentrated. The changes resulted in lower interest rates for some borrowers and new credit to borrowers who would not have qualified for mortgages before the regulatory change.

Easing standards does not necessarily imply imprudent lending. Loans may be just as sound even though extended to applicants who may not have qualified under stricter standards, if the more accessible standards are based on superior efficiency and risk assessment. Competitive discipline can instill both, as one study found. It analyzed direct evidence of prudential concerns and found competition positively correlated with financial stability.<sup>113</sup> Banks in competitive states were less likely to be targeted for regulatory enforcement and less likely to fail. Banks facing more competition earned lower-interest margins, made fewer high-risk investments, had lower profitability, and held less cash and Tier 1 capital than banks facing less competition.<sup>114</sup>

For these reasons, the implications of consolidation continue to merit careful consideration. Competition could be a cause, a consequence, or both, of consolidation. Likewise, consolidation could be salutary, neutral, or deleterious to competition. It is important to detect the distinctions and directions of causation, if any, in order to avoid false diagnoses and prescriptions that could fail to remedy problems or, worse, exacerbate them. It is even more important to discern as directly as possible the intensity and effect of competition itself, and to assess the external conditions that can affect it.

## 8.2.2 Credit Unions

As for credit unions, despite the shrinkage of federally insured entities to 5,200, the Bureau of Labor Statistics counted 17,000 total establishments in 2019, much closer to the 1972 tally in the

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<sup>112</sup> Di Maggio, Kermani, and Korgaonkar, *Partial deregulation and competition: Effects on Risky Mortgage Origination*, MANAGEMENT SCIENCE (2019). 10.1287/mnsc.2018.3060 [https://www.researchgate.net/profile/Sanket\\_Korgaonkar2/publication/327834191\\_Partial\\_Deregulation\\_and\\_Competition\\_Effects\\_on\\_Risky\\_Mortgage\\_Origination/links/5ba80a8b45851574f7e19b11/Partial-Deregulation-and-Competition-Effects-on-Risky-Mortgage-Origination.pdf](https://www.researchgate.net/profile/Sanket_Korgaonkar2/publication/327834191_Partial_Deregulation_and_Competition_Effects_on_Risky_Mortgage_Origination/links/5ba80a8b45851574f7e19b11/Partial-Deregulation-and-Competition-Effects-on-Risky-Mortgage-Origination.pdf)

<sup>113</sup> Akins et al. *Bank Competition and Financial Stability: Evidence from the Financial Crisis*. *Journal of Financial and Quantitative Analysis*, 1-28 (2016). <https://doi.org/10.1017/S0022109016000090>.

<sup>114</sup> Id.

NCCF's Report.<sup>115</sup> Like banks, credit unions have increased lending significantly over the past fifty years, even though the number of institutions has dropped. And as with banks, a simple institutional census of credit unions underestimates their competitive presence. Branching has kept the number of offices near their 1970 levels, and credit unions have become closer alternatives to banks and thrifts for consumer services. Credit unions take deposits, lend to consumers, issue cards, and finance purchases. Not surprisingly, studies find evidence of this competition in the rates that the institutions charge when they operate nearby one another. One study found that when credit unions were more prevalent in a market, credit card loan rates fell.<sup>116</sup> Another study, looking at regulation that allowed credit unions to compete more closely with banks, found that the increased competition was especially beneficial for low-income borrowers.<sup>117</sup> The cost of borrowing fell, banks became more efficient, and both banks and nonbank lenders extended more credit to riskier borrowers.

By the critical measure of the price of services, credit unions often beat banks, as they did when the NCCF studied the sector 50 years ago. Interest rates on credit cards averaged between 11 percent and 12 percent at credit unions, lower than average bank-card rates.<sup>118</sup> Other loans tend to be cheaper at credit unions as well. These advantages help explain why credit unions have seen their holdings of consumer credit grow faster than banks. Membership in credit unions passed 120 million members in 2019, an increase of about 50 million in 20 years.<sup>119</sup>

Some sizeable differences in the institutions play a role in the competition between the sectors. In credit unions' favor is their tax status. They are nonprofit entities, owned by their members, and therefore have lower tax expenses. In banks' favor is scale. They hold three times as much consumer credit on average as credit unions do, and credit unions are restricted to the consumer channel. The limitation means that commercial banks have the benefit, and of course bear the risk, of other holdings as well. Credit unions tend to be more regional and limited to members of

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<sup>115</sup> Bureau of Labor Statistics, Quarterly Census of Employment and Wages, available at [https://data.bls.gov/cew/apps/table\\_maker/v4/table\\_maker.htm#type=1&year=2019&qtr=4&own=5&ind=522130&supp=0](https://data.bls.gov/cew/apps/table_maker/v4/table_maker.htm#type=1&year=2019&qtr=4&own=5&ind=522130&supp=0)

<sup>116</sup> Feinberg, R., *Credit Unions: Fringe Suppliers or Cournot Competitors?* REVIEW OF INDUSTRIAL ORGANIZATION, 20(2), 105-113, (2002).

<sup>117</sup> Gissler, et al (2018), *supra* note 110.

<sup>118</sup> *Credit Union and Regional Bank Credit Cards*, CREDITCARDS.COM, available at <https://www.creditcards.com/credit-union/>. (The biggest advantage of a credit union credit card? It likely has significantly lower interest, possibly even offering rock-bottom interest on cash advances. In November 2018, the average interest rate offered by credit unions for credit cards was 11.1%, a steady figure over the last 10 years. That compares to the national average rate of 17.08% in March 2020."); See, also, <https://www.spglobal.com/marketintelligence/en/about/>.

<sup>119</sup> Monthly Estimates, CUNA.ORG (June 2020) available at [https://www.cuna.org/uploadedFiles/Global/About\\_Credit\\_Unions/CUMonthEst\\_Jun20.pdf](https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_Jun20.pdf).

identified organizations, although they do vary in size and geography. Large credit unions operate through branches, ATMs, and online across the country.

Banks and credit unions routinely measure themselves against each another. The institutions conduct annual surveys, which make headlines in the trade press. The most recent survey released by the American Bankers Association announced that for the first time, banks had beaten credit unions in customer satisfaction scores. The headline read, “Banks Outpace Credit Unions in Consumer Satisfaction.”<sup>120</sup> Banks did especially well with consumers’ ratings of staff, mobile apps, and speed of in-branch transactions. The best of all were regional and community banks, which outscored nationwide banks. While these results support the proposition that banks and credit unions compete closely with each another, they also demonstrate that the bundle of services both types of institutions provide, from personal relations to branch locations, gives them a significant advantage in retaining customers. Consumers may change credit cards, open new accounts elsewhere, or shop nationwide for loans and mortgages, but the established relationships with banks and credit unions are not often abandoned.

Competition between banks and credit unions is also apparent in the rivalry of their respective organizations. The two sectors are frequently at odds over public policies that might give one or the other an advantage. Bankers’ associations have opposed allowing credit union acquisitions of banks, allowing credit unions to expand loans to businesses, and allowing other extensions that threaten traditional bank business lines.<sup>121</sup> The banking sector criticizes as unfair the tax advantage of credit unions and cites it as a justification to limit their activities. Credit unions object to restrictions such as caps on commercial lending, which would allow them to enter more areas of competition with banks. It is not necessary to take a position on these arguments to conclude that the debate itself reveals potential competition between the two sectors. Evidence discussed below reveals other aspects of sectors’ rivalry. The barriers against credit-union expansion harken back to those that the NCCF deemed anticompetitive 50 years ago.

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<sup>120</sup> *Banks Outpace Credit Unions in Consumer Satisfaction*, ABA BANKING JOURNAL (2019), available at, <https://bankingjournal.aba.com/2019/11/banks-outpace-credit-unions-in-consumer-satisfaction/>.

<sup>121</sup> See, e.g. Melissa Angell, *Banks decry CU lobbying while beefing up own during coronavirus*, AMERICAN BANKER (May, 18, 2020), available at <https://www.americanbanker.com/creditunions/news/banks-decry-cu-lobbying-while-beefing-up-own-during-coronavirus>; see also Carrie Hunt, *The difference between banks and credit unions could not be clearer*, THE HILL, (February 5, 2019), available at <https://thehill.com/opinion/finance/428546-the-difference-between-banks-and-credit-unions-could-not-be-clearer..>



### 8.2.3 Finance Companies

Finance company establishments numbered just under 16,000 in 2019<sup>122</sup> ahead of the 13,000 to 14,000 offices estimated by the NCCF in 1970. For decades, with portfolios of direct and indirect loans, finance companies constituted the second largest sector of nonmortgage consumer credit. They offer a variety of loans for the purposes that send consumers to banks, credit unions, and retail lenders.<sup>123</sup> Although this sector has lost share to banks and credit unions since 1972,<sup>124</sup> it does not appear to be in decline. To the contrary, according to a report from Experian, finance companies are the fastest growing source of consumer credit, having increased by 50 percent in the past five years. For 2019, the report estimated that 11 percent of the population held 34.8 million different accounts and 6 million new accounts at finance companies.<sup>125</sup>

Innovation is driving this growth. According to the Experian report, FinTech lenders, continuing to offer new products and experiences, “have more than doubled their market share of unsecured personal loans in the past four years, from 22.4 percent in 2015 to 49.4 percent in 2019.”<sup>126</sup> By 2022, FinTech lenders are expected to increase those loans by another 50 percent. Whether FinTech lending meets the expectations of the analysts, its competitive presence is unquestionably established, and the comparative advantage of offices and branches is declining.

Although the sources of personal loans are new, consumers’ borrowing patterns are familiar. A 2019 Experian survey of consumers reported that 28 percent had used their personal loans for large purchases, 26 percent for debt consolidation, 17 percent for home improvements, and 9 percent to refinance existing debt.<sup>127</sup> In one important respect, consumers clearly have gained on past generations: The average annual percentage rate of 9.4 percent in 2019 was less than half the finance-company rates that the NCCF observed in 1972 (when prime rates were comparable). APRs found in this survey beat the rates that the NCCF found credit unions and

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<sup>122</sup> BUREAU OF LABOR STATISTICS, QUARTERLY CENSUS OF EMPLOYMENT AND WAGES (2019, available at [https://data.bls.gov/cew/apps/table\\_maker/v4/table\\_maker.htm#type=1&year=2019&qtr=4&own=5&ind=522291&supp=0](https://data.bls.gov/cew/apps/table_maker/v4/table_maker.htm#type=1&year=2019&qtr=4&own=5&ind=522291&supp=0)

<sup>123</sup> DURKIN et al. (2014), *supra* note 65, at 25.

<sup>124</sup> Statistical Release, Finance Companies (June 2020), available at <https://www.federalreserve.gov/releases/g20/current/g20.pdf>.

<sup>125</sup> Matt Tatham, *Personal Loan Debt Continues Fast-Paced Growth*, EXPERIAN, October 14, 2019, available at <https://www.experian.com/blogs/ask-experian/research/personal-loan-study/>.

<sup>126</sup> *Id.*

<sup>127</sup> Stefan Lembo Stolba, “Survey: Consumers Want Personal Loans for Large Purchases and Debt Consolidation,” September 16, 2019, <https://www.experian.com/blogs/ask-experian/survey-consumers-want-personal-loans-for-large-purchases-and-debt-consolidation/>.

banks charging 50 years ago.<sup>128</sup> Credit union members in 2019 still cited better rates as a reason for borrowing there.

Like banks and credit unions, finance companies range from smaller, local establishments to cross-country networks. Many, including industry leaders, extend credit entirely online. They offer personal loans, mortgages, auto loans, and other types of credit. Banks regard them as attractive acquisitions. In September 2020, the appeal of finance-company acquisitions was described in the “American Banker,” which reported that “card networks, along with PayPal and Citi, are responding to competition from the likes of Affirm, Afterpay and other “buy now, pay later” lenders. Should traditional credit card lenders be worried?”<sup>129</sup> The answer to this rhetorical question was not necessary to reveal. For personal finance loans at least, product distinctions do not raise a high barrier between the sectors. Enthusiasm among banks for finance-company acquisitions remains keen, and the reason is the ability of finance companies to take business away from other types of institutions.

In short, the border between banks and finance companies does not appear to be a natural barrier, at least where loans are concerned. A century ago, banks began to open consumer-finance divisions and offer products that emulated finance-company loans. In 1972, the NCCF reported on banks’ buying finance companies for the same reason. Acquisitions, rather than internal growth, became a more attractive way to compete because regulations prevented banks from offering the terms that finance companies could offer. Today, the finance-company sector remains an inviting business for entry from the banking sector.

## 8.3 Competition from the Consumer’s Perspective

Consumers are constantly shopping for credit. They open 200 million accounts on average every 12 months, while they close another 200 million. This turnover represents more than a quarter of all accounts outstanding. In 2020, consumers held about 500 million credit card accounts, 100 million auto loans, 75 million mortgages, and about 20 million home equity lines of credit.

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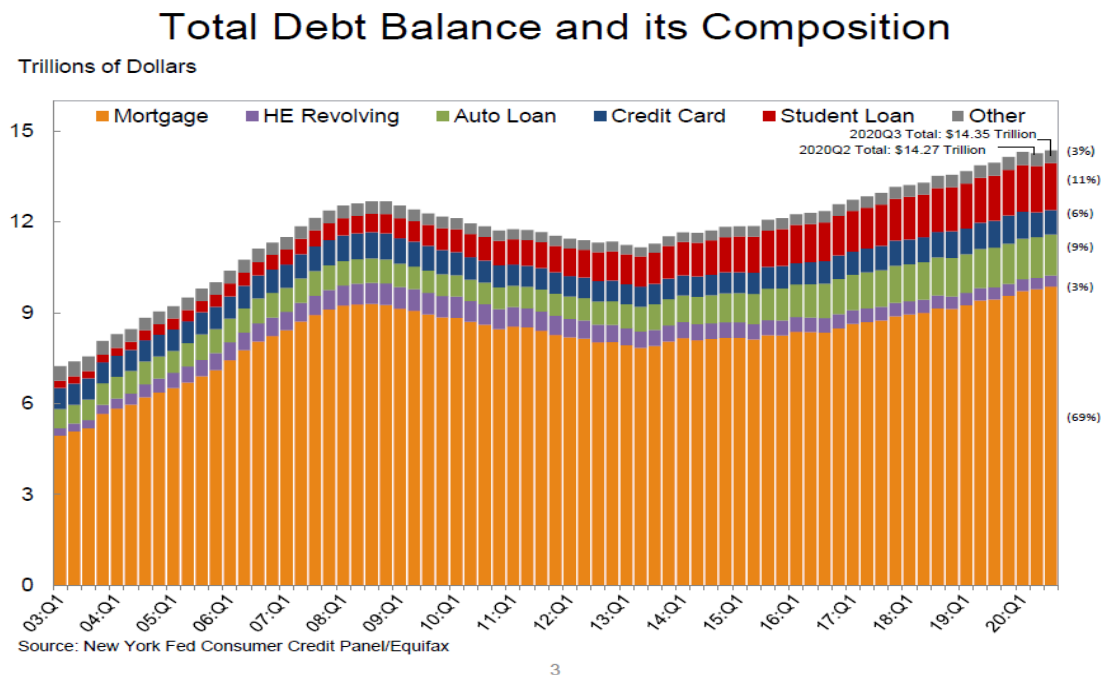
<sup>128</sup> NCCF (1972), *supra* note 5, at 128. (In 1972, credit unions charged - 11.76%, banks - 13.04%, and finance companies - 25.88%. The prime rate fluctuated around 5% in both 1972 and 2019.)

<sup>129</sup> Kevin Wack, *Why Visa and Mastercard are suddenly keen on installment lending*, AMERICAN BANKER, (September 02 2020), available at <https://www.americanbanker.com/tag/consumer-lending>



Their holdings amounted to \$14.35 trillion in the third quarter of 2020, about twice the level of 2003, as Figure 8.11 shows.<sup>130</sup>

**FIGURE 8-11: TOTAL DEBT BALANCE AND ITS COMPOSITION**



The assessment of competition typically begins with a definition of the market, which means taking the perspective of consumers and determining what they would regard as suitable substitutes for a product or service they desire.<sup>131</sup> Because financial services facilitate the consumption of something else, demand for those services is shaped by the ultimate purposes a consumer has in mind. Chapter 3 explains that for both borrowing and saving, a significant consideration is the time horizon—how long a consumer wants the use of a loan or when a consumer wants to retrieve funds deposited for future spending. Short-term loans and time deposits are more likely to be the leading options for consumers with temporary needs or seasonal shopping. Longer terms likely work better for home mortgages and retirement savings. Other aspects of a financial transaction bear on substitutability as well. Price, convenience, and customer service may make dissimilar products more or less appealing to a shopper with a

<sup>130</sup> NEW YORK FED, QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT, 20 20:Q3 (November 2020) [https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC\\_2020Q3.pdf](https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2020Q3.pdf).

<sup>131</sup> The process of market definition is described in merger guidelines issued by enforcement agencies. See DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES, (2010), available at <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010>.

particular purpose in mind. When significant time is not involved—for example when financial services simply facilitate payments—the most important features are likely to be reducing the costs and enhancing the efficiency of transactions.

Consumers use some financial services that they do not choose directly. While they select their lenders and depository institutions, the services they consume include components that the vendor has chosen. Just as a car owner may not know who produced the mechanics or body parts of an automobile she has just purchased, borrowers may not be aware of the companies that sell services that support a loan they have just taken out. A borrower does not select the credit reporting agency that provides information on his credit history or the loan servicer who collects payments. Nonetheless, the costs and quality of these services affect the price and availability of the loan. Accordingly, this chapter will consider competition in services provided in markets where financial institutions shop.

Few (if any) clear distinctions exist among the lengths that loans can run. Some credit needs expire in days, while others may extend for weeks, months, or years. Likewise, some credit products are designed for shorter or longer periods, while others can meet needs of almost any duration. Terms, of course, are not determinative. A longer loan at a lower rate may be a good substitute for a shorter loan at a higher rate. Accordingly, a competitive analysis should not conclude until the most determinative aspects of financial services are taken into account.

Because credit is fundamentally about accelerating or postponing purchases – whether for emergencies that require immediate payment, home prices that exceed available cash, saving for retirement, or myriad other decisions – this analysis will begin with the time dimension and then consider the other factors. The analysis will cover three general categories: short-term, medium-term, and long-term credit. We expect to find that borrowers in the market for short-term credit will look at products designed to meet those needs. A loan to repair the car until the next paycheck will likely come from a short-term or medium-term source. A loan to finance a house or car purchase will likely come from a provider of multi-year loans. Within each category, the analysis will consider the offers available to consumers and the competition among providers extending those offers. It is possible that the evidence will reveal that some products within each group do not compete in all respects with one another, and equally conceivable that the products in some groups compete with other products outside the groups.

Even within the groupings, different products offered by different institutions may be sufficiently distinct that they do not compete meaningfully with one another. As the NCCF observed, loans from remote sources may not provide a competitive constraint on convenient outlets, even when the loans may have similar features. Second mortgages can and do finance

car purchases, for example, but the vast majority of cars are financed by automobile loans.<sup>132</sup> Consumers can and do reallocate debt by delaying a payment to one creditor to obtain funds for another purpose, but those options may impose greater costs. In most cases, however, the leading edge of competition will come from providers more closely situated within categories.

Financial services can be customized in numerous ways. Terms depend on the information that borrowers and lenders bring to the transactions, their respective bargaining skills, economic expectations, credit history, and attitudes toward risk. All those contribute to an assessment of the likelihood that the borrower will repay the loan. Because borrowers vary widely on that spectrum, and because financial services are personal transactions, terms and services can be tailored to individual borrowers.

The most important influences on affordability and availability are the credit histories and credit scores of borrowers. Although several scores are available (the market for credit scoring is discussed below), the most frequently used measure is a FICO Score from the Fair Isaac Corporation. Table 8-2 below lists consumers within each FICO group and Table 8-3 lists types of credit by maturity. Creditors are more likely to lend and more likely to give favorable terms to consumers in better risk categories. Borrowers with poorer FICO grades will find fewer choices in the marketplace. Borrowers with the poorest scores or insufficient credit history to generate any score at all, will have even fewer choices.

According to one study, about a third of Americans have a FICO Score below 669, often considered "subprime" scores by lenders, and about half of them are classified as "very poor" (although that lowest category is no longer publicized). For comparison, the 67 percent of consumers who hold credit cards and the 62 percent who have retailers' cards have average scores in the low 700s.<sup>133</sup>

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<sup>132</sup> 85% of new cars; 55% of used cars financed, see Melinda Zabritski, *State of the Automotive Finance Market*, EXPERIAN, Q4 (2019), available at <https://www.experian.com/content/dam/marketing/na/automotive/quarterly-webinars/credit-trends/2019-q4-state-of-the-automotive-finance-market.pdf>.

<sup>133</sup> Matt Tatham, *2019 Consumer Credit Review*, EXPERIAN, (January 13, 2020) (The average credit card debt for Americans reached \$6,194 in 2019, as balances increased 3% compared with 2018, according to Experian data. The average FICO® Score for consumers with a credit card is 727, and 67% of Americans carried a credit card in 2019. <https://www.experian.com/blogs/ask-experian/consumer-credit-review/>).

**TABLE 8-2: PERCENT OF AMERICANS BY FICO® GRADES AND SCORES 2019<sup>134</sup>**

FICO Grade	Score	Share of Total
Poor	300-579	16%
Fair	580-669	18%
Good	670-739	21%
Very good	740-799	25%
Exceptional	800-850	20%

**TABLE 8-3: RETAIL CREDIT PRODUCT GROUPINGS**

Short Term	Medium Term	Longer Term
Pawns / Title Loans	Credit Cards	Auto Loans
Small Dollar Loans Payday Loans	Installment loans	Installment loans
Overdraft Protection	Overdraft Line of Credit	Mortgages
Credit Cards		

Credit scores rise with the age of consumers. A breakdown by cohorts was reported by Experian, using VantageScore—a joint product of the three national credit bureaus, which is comparable to the FICO Score. For Gen Z, the average is 656; Gen Y, 658; Gen X, 676; boomers, 716; and the Silent Generation, 729.<sup>135</sup> In other words, two generations of Americans have yet to raise their average credit risk to good or better, and the average obscures the circumstances of the constituents; every generation has at any time some members struggling with credit status. Because below-average grades limit borrowers' options in the market for financial services, the competition they encounter can vary substantially.

<sup>134</sup>, *MyFICO*, FICO, available at <https://www.myfico.com/credit-education/credit-scores>.

<sup>135</sup> Stefani Wendel, *State of Credit 2020: Consumer Credit During COVID-19*, EXPERIAN. Available at <https://www.experian.com/blogs/insights/2020/10/state-credit-2020/>. VantageScore breaks the bottom range into two categories – deep subprime (or bad credit) from 300 to 499 and poor credit from 500 to 600.

### 8.3.1 Short-Term Loans – Overdrafts, Payday Loans, Pawnshops, Personal Loans

Most borrowers need not look for short-term loans, because they have alternatives available from numerous sources and can tap them as easily as swiping a credit card. Anyone who has a credit card can obtain an advance for 15 days, a few months, or a few years, and people with FICO Scores in the mid-600s or above can typically qualify for cards—Their options for short-term loans are virtually unlimited.

For consumers with the lowest scores or thinnest files, however, the options are more likely limited to short-term, small-dollar loans. Low-income and thin-file consumers, like their predecessors a century ago, often unbanked or underbanked, may have to choose among the lenders that specialize in short-term credit. These are the businesses that make installment loans, pawn loans, vehicle title loans, and payday loans. As noted in Chapter 3, these products together amounted to about \$75 billion in recent years, a small fraction of the \$4 trillion in consumer debt outstanding. Similarly small is the proportion of households using these loans; it is under 2 percent for each type.

Nonetheless, providers are abundant, counting in the tens of thousands, and the sector is sometimes criticized for being *too* competitive. A common comment about the estimated 18,000 payday lenders is that they are more ubiquitous than McDonald's or Starbucks.<sup>136</sup> Indeed, a payday loan office requires less capital and fewer employees than a typical McDonald's restaurant impeded. Those restrictions aside, entry barriers would be nonexistent, which explains why the number of providers, like their counterparts in the early 20th century, remains high.

In addition to payday lenders, borrowers with few other options have access to some 10,000 pawnshops according to the National Pawnbrokers Association. Significant overlaps exist in product characteristics and prices among pawnshops, payday lenders, and overdraft protection services. Some research has found rates to be comparable,<sup>137</sup> which suggests the three may be in one market. A study of alternatives to payday lending in Ohio, after legislation capped payday rates at 28 percent and caused payday lenders to shut down, found that pawnshop licenses grew

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<sup>136</sup> Tim Ranzetta, *Which business has the most physical locations in the US: McDonald's, Payday Lenders, or Starbucks?*, NGPF (2019), <https://www.ngpf.org/blog/question-of-the-day/qod-which-business-has-the-most-physical-locations-in-the-us-mcdonalds-payday-lenders-or-starbucks/>.

<sup>137</sup> Not found in the resources reviewed to date is an accounting for the cost of convenience of the three options. Payday convenience for example, may be worth more than the difference interest payments, while security forfeitures, if factored into interest rates, would increase borrowing costs at pawnshops.

by 97 percent.<sup>138</sup> Discussed later in this chapter, the ability of banks to compete for small-dollar, short-term loans has been hampered by regulations discouraging such loans and limiting overdraft charges. P2P, friends and family may be available to consumers who cannot access banks and finance companies, but these informal sources are beyond the scope of this chapter.

On the question whether payday loans compete with other types of loans, Durkin, et al. report that significant interinstitutional competition arose after the relaxation of rate ceilings and other restrictions in the 1980s and 1990s.<sup>139</sup> Evidence for that competition was described in a 2013 article:

Competition benefits consumers in the alternative consumer credit markets just as it does in any other market, providing consumers with the opportunity for lower prices, innovation, and higher-quality service. Although prices seem high for both payday loans and overdraft protection, there is no evidence that either product generates sustainable economic profits (as opposed to normal economic returns). Payday loan prices generally reflect underlying risk and operating costs. There is no evidence of supranormal economic (or monopoly) returns to firms in the payday lending industry, indicating the competitive nature of the market. Barriers to entry in the payday lending market appear to be low.<sup>140</sup>

Competition between payday lenders and less expensive sources of credit might be more robust but for barriers that have prevented entry into the payday space. In 2003, OCC discouraged banks from offering short-term, small-dollar loans. When banks tried to compete anyway—for example, by offering overdraft protection—the Fed restrained those efforts with additional restrictions in 2009. The effects were immediate, according to Evans, Litan, and Schmalensee, who found, “within days” of the Fed’s announcement of its new overdraft rules, banks started scaling back access to checking accounts, which meant diminished availability of credit services associated with them, such as deposit advance.<sup>141</sup>

Still, banks have demonstrated that entry is difficult to suppress in markets where consumers are paying high prices. Community banks and credit unions have offered variations of payday loans for several years, and more recently, large banks have introduced similar products. Since 2018, US Bank has offered loans of \$100 to \$1,000 at fixed fees of \$12 to \$15 per \$100, and

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<sup>138</sup> Stefanie R. Ramirez, Payday-loan bans: evidence of indirect effects on supply. *Empir Econ* 56, 1011–1037 (2019). <https://doi.org/10.1007/s00181-018-1447-2> (Licenses for small-loan companies increased by over 150%.)

<sup>139</sup> DURKIN et al. (2014), *supra* note 65, at 506–509.

<sup>140</sup> Clarke and Zywicki, Payday Lending, Bank Overdraft Protection, And Fair Competition At The CFPB, *REVIEW OF BANKING & FINANCIAL LAW*, Vol. 33, No. 1, pp. 235–281, at 258 (2013).

<sup>141</sup> *Id.* at 263 (citations omitted).

Bank of America is currently rolling out a plan with a \$5 flat fee for loans of \$100 to \$500. Both plans allow three months to repay. APRs on those loans depend on their duration, since quicker repayments raise rates, but borrowing costs over three months can translate into substantial savings over payday and other small-dollar loans—about 70 percent for US Bank and 6 percent to 30 percent for Bank of America, compared with an average of 90 percent for installment loans under \$1,500 and 400 percent for a typical payday loan.<sup>142</sup> Some banks still offer overdraft protection and direct-deposit-advance products that may compete with small-dollar lending.<sup>143</sup> Consumers who opt in to such services tend to be credit constrained: Compared with others, they have lower credit scores, are less likely to have a general-purpose credit card, and are more likely to have low limits on cards they do have.<sup>144</sup> Payday borrowers display similar profiles. In markets where banks offer those products, borrowers may benefit from the additional competition. And some credit unions offer payday alternative loans, or PALs, which typically run for longer terms at lower rates.<sup>145</sup>

Online information available to consumers suggests that pawns, personal loans, and payday loans may be alternatives to one another. According to Credit Karma, a marketer that combines advertising with advice, the average pawnshop loan is \$150, and pawnshops are no longer confined to inconspicuous storefronts and strip malls. Online sites will pawn items worth hundreds (or, they claim, millions) of dollars. For consumers considering a pawnshop, however, Credit Karma, a marketer that combines advertising with advice, suggests web-based peer-to-peer options, negotiating extensions with current creditors, and approaching neighbors and friends. In a clue that payday loans are another alternative to these sources, Credit Karma cautions against the payday option because it is “terribly costly.”<sup>146</sup> With the advice comes advertising for numerous short-term and medium-term loans for the consideration of the

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<sup>142</sup> See, e.g. Lisa RowanForbes, “New Small-Dollar Loans From Bank Of America Offer Alternative To Expensive Payday Loans,” *Forbes Advisor* Oct. 14, 2020, <https://www.forbes.com/sites/advisor/2020/10/14/new-small-dollar-loans-from-bank-of-america-offer-alternative-to-expensive-payday-loans/?sh=6b89ae892306>.

<sup>143</sup> CFPB, CFPB STUDY OF OVERDRAFT PROGRAMS: A WHITE PAPER OF INITIAL DATA FINDINGS (June 11, 2013), available at [https://files.consumerfinance.gov/f/201306\\_cfpb\\_whitepaper\\_overdraft-practices.pdf](https://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf). (“Between 20% and 27% of accounts opened in 2011 had one or more overdraft or NSF transaction. ...Between 13.5% and 27.8% of accounts with at least one overdraft or NSF transaction had at least 10 such transactions.”)

<sup>144</sup> CFPB, DATA POINT: FREQUENT OVERDRAFTERS (Aug. 4, 2017), available at [https://www.consumerfinance.gov/documents/5126/201708\\_cfpb\\_data-point\\_frequent-overdrafters.pdf](https://www.consumerfinance.gov/documents/5126/201708_cfpb_data-point_frequent-overdrafters.pdf).

<sup>145</sup> Liz Weston and Amrita Jayakumar, *What Is a Payday Alternative Loan?* NERDWALLET (December 3, 2019) available at <https://www.nerdwallet.com/article/loans/payday-alternative-loan-pal>

<sup>146</sup> Anna Baluch, “Is a pawn shop loan a good idea for quick cash?” Credit Karma, ? CREDIT KARMA (Updated July 19, 2019, ), available at <https://www.creditkarma.com/personal-loans/i/pawn-shop-loans/>.



potential payday shopper. Information about products and providers is plentiful on the site, one of many that borrowers can check for alternatives to payday loans.

Payday loans and similar products may be costly, but cost depends on context and by itself reveals little about competition. McDonald's and Starbucks charge more for food and drink than other chains, but less than full-service restaurants, most of which contend with constant competition.<sup>147</sup> No restaurant, however, would make economic sense to consumers as a sole source for food or coffee. By the same token, a hotel room would not make sense as a yearlong residence, even though competition and depressed travel have pushed the average nightly rate down to \$100 in the U.S. in 2020. A \$100 nightly rate is a bargain by historical standards, but it translates into an annual cost of \$36,500, quite expensive for a studio apartment without a kitchen. Paying seemingly exorbitant annual costs of an occasional product or service does not necessarily indicate misguided consumers or malfunctioning markets.

Surveys of payday loan borrowers conducted by The Pew Charitable Trust and Advance America (one of the country's largest payday lenders), found that consumers consider various options to obtain short-term credit, including skipping payments to existing creditors, borrowing from family, overdrawing their bank account, and taking out a small-dollar loan.<sup>148</sup> Academic research described in Chapter 10 has found that bans on payday loans cause customers to shift to these options, and in states that ban the loans consumers cross borders to borrow if neighboring states permit them.<sup>149</sup>

That consumers resort to alternatives does not necessarily indicate that they are close substitutes. When a service is unavailable altogether, consumers may settle for inferior options that they would not have chosen in a competitive market with numerous options. A survey commissioned by the industry lends some support to the superiority of payday loans over their closest alternatives. Nearly 75 percent of the small-loan or payday borrowers surveyed said they could not find an alternative when they took out their last loan.<sup>150</sup> These are borrowers who

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<sup>147</sup> See, e.g. Andrea Marie Leschewski and Dave D. Weatherspoon, Fast Food Restaurant Pricing Strategies in Michigan Food Deserts, *International Food and Agribusiness Management Review* Volume 17 Special Issue A, 2014, (surveying literature).

<sup>148</sup> See, e.g. The PEW Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why*, (2012), available at <https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why>; Advance America, *Release, 92% of Borrowers Choose Payday Loans Over Competing Credit Products* <https://www.advanceamerica.net/news/92-of-borrowers-choose-payday-loans-over-competing-credit-products>.

<sup>149</sup> See, e.g. Ramirez, *supra* note 138.

<sup>150</sup> *Payday Borrowers Are Far More Favorable Toward and Informed About Payday Loans than Voters without Payday Loan Experience*, PR NEWSWIRE, March 14, 2016, <https://www.prnewswire.com/news-releases/new-survey--payday-borrowers-are-far-more-favorable-toward-and-informed-about-payday-loans-than-voters-without-payday-loan-experience-300235446.html>



either had reached their credit limits or could not secure credit cards, installment loans, second mortgages and other loans offering more attractive terms. For people in these circumstances today, like the small-dollar borrowers of a century ago, competition within the sector can offer consumer protection, and innovation could dramatically reshape competition in the sector. Banks' continue to enter the space, and nonbank payment systems are beginning to bridge the gap between credit invisibles and financial institutions that can lend at much lower costs. These developments are described at the end of the chapter.

### 8.3.2 Medium-Term Credit – Credit Cards, Lines of Credit, Installment Loans

For consumers who are considered good-to-excellent credit risks, the marketplace for financial services is vast, including multiple medium-term credit instruments, and it is this category that has been the largest contributor to the growth of nonmortgage consumer credit held by banks. Credit cards account for most of that growth. At the time of the NCCF's Report, revolving credit at retailers far exceeded the amount on bank cards. Today, the positions are reversed. Numerous factors explain these trends, starting with convenience. Consumers who once carried cards for gas stations, department stores, travel companies, and specialty retailers have gradually lightened their load of plastic to a few favorites, commonly including a bank card that could substitute for the other accounts.

Consumers open about 6 million credit card accounts a month, and the vast majority of those originations by dollar volume come from consumers with good and better credit scores. According to CFPB data, subprime consumers (with scores below 620) originate less than a billion dollars of credit card debt a month, while near-prime consumers (620-659) open about \$1.5 billion. Together they account for less than a 10 percent of the \$30 billion that consumers rated at prime and above (660 and up) open up on new cards.<sup>151</sup>

Most of the products in this category can substitute for products in the other two. Consumers who qualify for any of the medium-term loans are likely to be sufficiently creditworthy to avail themselves of any of the other medium-term or short-term options as well. Marketing makes it clear that banks and finance companies are competing across their sector boundary and offering consumers alternatives to credit card debt. Comparative advertising is often an indication of products that are likely substitutes for one another, and such advertising is plentiful. As an

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<sup>151</sup> CFPB, Borrower Risk Profiles, <https://www.consumerfinance.gov/data-research/consumer-credit-trends/credit-cards/borrower-risk-profiles/>.

example, one of the top online lenders makes an appeal to cardholders that leaves little doubt that an installment loan is an alternative to credit card balances:<sup>152</sup>

**FIGURE 8-12:** ADD COMPARING PERSONAL LOAN AND CREDIT CARD

Rocket Loans Personal Loan		High-Interest Credit Cards	
Loan Amount	\$10,000.00	Loan Amount	\$10,000.00
Monthly Payment	217.42	Monthly Payment	217.42
Origination Fee	500.00	Origination Fee	N/A
Interest Rate	11.00%	Interest Rate	12.99%
APR	13.26%	APR	16.00%
Time to Pay Off	5 years	Time to Pay Off	6 years
Finance Charge	\$3,545.45	Finance Charge	\$5,594.23
<b>-\$2,548.78</b> <small>Less in interest</small>		<b>+\$2,548.78</b> <small>More in interest</small>	

It is conceivable that a comparison of alternative sources of credit could determine that credit cards would not qualify as a market solely on the basis of consumer demand for loans. Nonetheless, because bank cards have gained such a large share of consumer credit, it is useful to consider the competition just among credit cards. Different cards offer a variety of interest rates and other terms. Cards from credit unions routinely offer better rates. The industry makes hundreds of millions of offers a year, enticing consumers to try new cards with lower fees, lower interest rates, more bonuses, and other attractive features. Merchants still take advantage of the opportunity at checkout to offer charge accounts. Consumers routinely acquire new cards to pay off more expensive debts. New credit cards have represented about a third of the 200,000 new accounts opened in recent years.<sup>153</sup> Medium-term credit is a thriving marketplace with myriad options for consumers.

<sup>152</sup> Rocket Loan Home Page, <https://www.rocketloans.com/>. Accessed on September 3, 2020.

<sup>153</sup> Credit card openings from CFPB, see *Consumer Credit Trends Credit Cards*, available at <https://www.consumerfinance.gov/data-research/consumer-credit-trends/credit-cards/origination-activity/>. All account openings from New York Fed (2020), *supra* note 130.

### 8.3.3 Installment Loans

The National Installment Lenders Association (NILA) stresses differences among installment, payday, and title loans—an indication of competition across the short-term and mid-term categories of credit:

These products are about as different as two products could be. [P]ayday companies do not test the ability to repay the loan from cash flow....Loans are typically of two weeks or one month's duration, and are payable in one lump sum....Data on these loans is not accepted by any major credit bureau. By contrast, traditional installment lenders do test the ability to repay, and the loans are payable in equal installments of principal and interest, giving the borrower a clear and manageable roadmap out of debt. Installment loans are reported to the credit bureaus, enabling responsible borrowers to build or repair their credit.<sup>154</sup>

Credit Karma's website search engine returns four companies with 11 options to an inquiry for a personal loan.<sup>155</sup> The APRs for a shopper (presumably anonymous and unscreened) ranged from 18 percent to more than 30 percent. Clicking a link for a lender allows one to apply for a loan. The ease of searching for loans, comparing offers, and securing funds with an online session, at rates approximating credit card rates, is an indication of competition, especially for those consumers with lower credit scores and in need of short-term cash. That installment loans attract multiple grades of borrowers and multiple sources of lenders suggests that they present alternatives for consumers considering many purposes. Characterized by one study as credit for the non-prime working classes, but better risks than payday borrowers, the business has grown dramatically. Non-prime borrowers owe an estimated \$50 billion on installment loans, borrowed from lenders that have avoided the public opprobrium and regulatory backlash that payday lenders have attracted.<sup>156</sup>

The actual interest rates that consumers pay will depend on whether they avail themselves of the benefits of competition. As is the case in any market, prices, terms, and conditions vary, and the variations can reflect competition, as consumers do not have identical preferences. Some consumers may be satisfied with their current lenders and prefer not to shop around, even though they might find themselves paying higher APRs than those who compare. Lending Tree, a company that facilitates loan shopping, surveyed personal loans available to borrowers with

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<sup>154</sup> National Installment Lenders Association, *Fundamentals*, available at <https://nilaonline.org/fundamentals/> (internal notations deleted).

<sup>155</sup> Credit Karma, available at <https://www.creditkarma.com/shop/personal-loans#newloans>

<sup>156</sup> Profile from Payments Journal, *The Ugly Side of Lending: Online Installment Loans* <https://www.paymentsjournal.com/the-ugly-side-of-lending-online-installment-loans/>

different credit scores. As replicated in Table 8-4, the difference between the minimum and maximum rates exceeded eight percentage points for borrowers in all categories – from subprime to excellent scores. On an average three-year loan of about \$10,000, that difference translated into more than \$1,600 in extra payments, even for the best credit risks.<sup>157</sup>

**TABLE 8-4: SHOPPING AROUND FOR PERSONAL LOANS DIFFERENCE IN LOAN TERM OFFERS FOR THE AVERAGE 3-YEAR PERSONAL LOAN (\$10,328) MAY 2018**

Credit score range	Avg APR Offers Min	Avg APR Offers Max	Avg APR Offers Spread	Monthly Payments Min	Monthly Payments Max	Monthly Payments Spread	Total Payments Over 3 Years Min	Total Payments Over 3 Years Max	Total Payments Over 3 Years Spread
640 - 679	24.46%	33.01%	8.55%	\$408	\$456	\$48	\$14,678	\$16,404	\$1,726
680 - 719	17.19%	26.02%	8.83%	\$369	\$416	\$47	\$13,291	\$14,984	\$1,694
720 - 759	10.69%	19.97%	9.28%	\$337	\$384	\$47	\$12,118	\$13,812	\$1,695
760+	7.55%	16.38%	8.82%	\$322	\$365	\$44	\$11,575	\$13,141	\$1,566
<i>All Borrowers</i>	18.51%	27.30%	8.79%	\$376	\$423	\$47	\$13,538	\$15,239	\$1,701

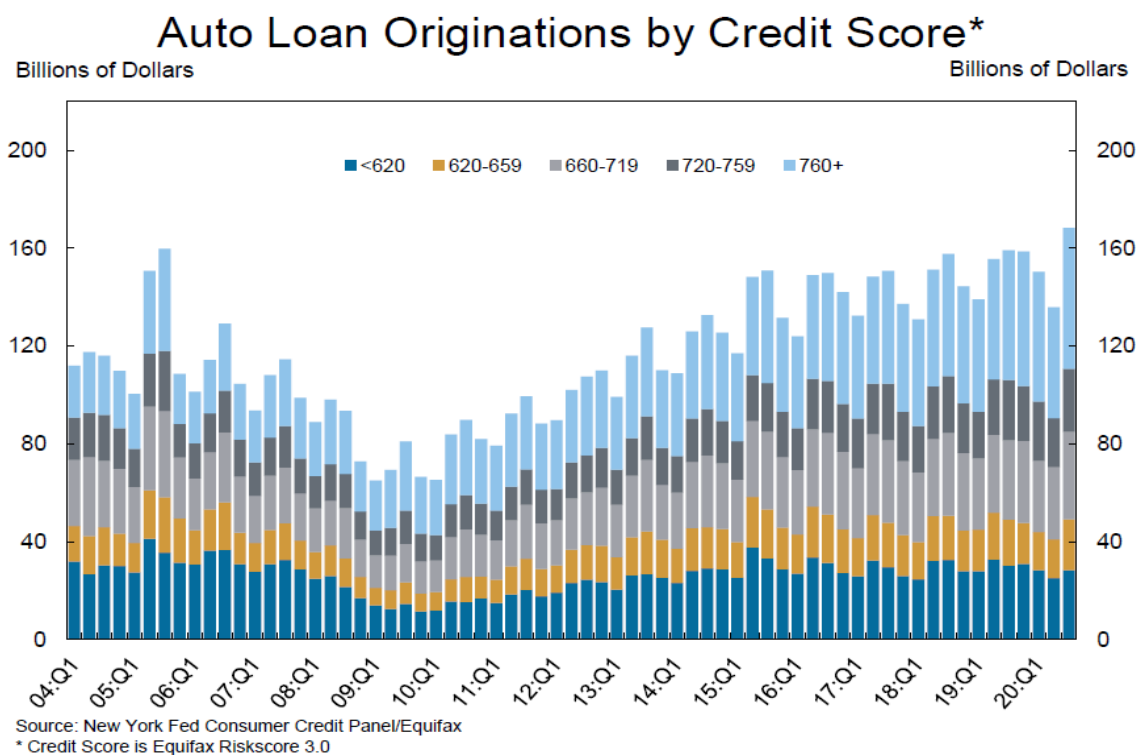
### 8.3.4 Long-Term Products – Automobiles and Mortgages

Lending for automobile purchases was found competitive by the NCCF in 1970, and it appears to be so today. Auto loans may constitute a relevant market, given the maturities and securities involved. Car buyers may cross sector borders and borrow funds from other sources of secured loans (such as second-mortgage lenders), but unsecured loans are likely to be significantly more expensive than a loan backed by the security of a lien on the vehicle. Auto loans can come from banks, credit unions, thrifts, manufacturers, and the dealers themselves (although auto dealers typically act as middlemen for other institutions that provide credit).

<sup>157</sup> Kat Khoury , *LendingTree Study: Shopping Around for Personal Loans Can Save Consumers 35%*, (June 27, 2018). <https://www.lendingtree.com/personal/lendingtree-study-shopping-around-for-personal-loans-can-save-consumers-35/>.

Even though consumers with poor credit can find lenders willing to finance auto purchases, two-thirds of those loans are taken out by consumers with credit scores of 660 and above, the proportions have remained relatively constant in the past decade, as Figure 8-13 shows.<sup>158</sup>

**FIGURE 8-13: AUTO LOAN ORIGINATIONS BY CREDIT SCORE**



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Auto loans, like installment loans, depend in part on the shopper to determine what they desire. Surveys reflect consumers have abundant choices for auto credit, and they express varying interest in different aspects of those options. In 2015, roughly half of them shopped around for financing,<sup>159</sup> while the other half chose the convenience of one-stop shopping at the dealer. A

<sup>158</sup> New York Fed (2020), *supra* note 130.

<sup>159</sup> CFPB, CONSUMER VOICES ON AUTOMOBILE FINANCING, 8 (2016).

2019 survey reported by FICO Decisions found similar results, and asked consumers about their loans or leases.<sup>160</sup> Eighty percent of the respondents negotiated terms – the most important of which were the monthly payment amount (cited by 92 percent ), the length of the loan (90 percent), and the APR (87 percent ), Ninety percent of the respondents felt they received good (53 percent) or excellent (36 percent ) deals on their loans or leases. Ten percent regarded their deal as poor (8 percent ) or felt cheated (2 percent ). Two thirds of the respondents reported that the level of financing had some or a great deal of their selection of the vehicle make, model, or dealership. The bottom line from the survey, according to FICO’s summary:

At the end of the day, US consumers want speed, convenience, fairness, and value. They dislike lengthy paperwork. They want to be treated as individuals, and they want to complete the transaction on the channel that works best for them. Some prefer the convenience of going online, some appreciate the one-stop shopping you can get at a dealership, and others like and trust their bank and prefer to go there. Some academic studies that have focused on the effects of borrower qualifications and demand characteristics have found that opportunities for exploiting customers arise in the personal negotiations that attend an automobile purchase. One study concluded that consumers are more sensitive to maturity and payment size than the interest rate, which means that some end up paying higher rates than others, despite similar credit qualifications.<sup>161</sup> A 2010 study of negotiations for auto loans found that search costs, incomplete information, and distaste for bargaining leave consumers worse off.<sup>162</sup> The authors estimated that better-informed consumers captured 15 percent of the average dealer margin from selling an automobile. Nonetheless, a substantial group of consumers did not access the information that would have saved them that money. Comparison shoppers got lower rates while customers who preferred convenience paid more.<sup>163</sup>

Consumers paying different interest rates on auto loans have been the subject of numerous studies and proposals. A Bureau initiative would have capped the mark-ups that dealers could add to the rates that banks charged them.<sup>164</sup> A recent article in “The Georgetown Law Journal” proposes a three-day cooling-off period before consumers would be allowed to drive a dealer-

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<sup>160</sup> Micah Dubois, *2019 Global Consumer Survey of Vehicle Finance Perception*, FICO BLOG (March 2019), available at <https://www.fico.com/blogs/2019-us-consumer-survey-vehicle-finance-perceptions-5-takeaways>

<sup>161</sup> Bronson Argyle, Taylor Nadauld, Christopher Palmer, *Monthly Payment Targeting and the Demand for Maturity*, NBER Working Paper No. w25668 19 (March 2019).

<sup>162</sup> Economics of Auto Loans, see Scott Morton, F., Silva-Risso, J. & Zettelmeyer, F. *What Matters in a Price Negotiation: Evidence From the U.S. Auto Retailing Industry*. QUANT MARK ECON, 9, 365 (2011), available at <https://link.springer.com/article/10.1007/s11129-011-9108-1>

<sup>163</sup> For more on competition in automobile credit, see the discussion of access and inclusions in Chapter 10.

<sup>164</sup> See Chapter 10 for a discussion of this policy and its effects.

financed car off the lot, unless they have first shopped elsewhere for direct sources of credit.<sup>165</sup> Proposals such as these often underestimate or overlook the ability and desire of consumers to take advantage of competition. Both the FTC and the CFPB have interviewed consumers for their perspectives on financing, and consumers explained why they had agreed to the terms they took.<sup>166</sup> Some consumers simply did not like to bargain. Others thought their credit scores left them with little choice at the time. However, consumers who thought their rates were too high had not given up on improving them; they frequently said they intended to refinance. Those with marginal credit scores wanted to make some payments and improve their credit scores before they sought better rates. Whenever consumers might reenter the market, those seeking to improve their deals will find dozens of options available from numerous creditors, often marketed by online guides listing the top choices along with calculations of how much consumers can save.<sup>167</sup> The availability of these options and their value to consumers should be considered in any cost-benefit analysis of policies that mandate behavior, restrict choices, or fix terms at dealerships. FICO's survey asked consumers what the ideal automotive buying and financing experience would be for them. The word that they used more than any other in their answers (except for "car") was "easy."

The longest terms that consumers consider for loans are typically in mortgages for the homes they buy. Recent studies of mortgage loans describe an unconcentrated sector experiencing dynamic activity and compressed profits. Independent mortgage bankers are gaining market share, and profit margins are declining across the board, according to one study.<sup>168</sup> A Note by economists at the Fed found the relevant markets for mortgages to be nationwide and mortgage rates to be unrelated to local concentration, which itself was low in most areas, even if location had mattered.<sup>169</sup> Consumers do not place much importance on the location of a mortgage lender, according to the Fed's Surveys of Consumer Finances, and more than half the mortgages are originated by nonlocal lenders. Perhaps most striking about the state of competition in the

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<sup>165</sup> Adam Levitin, *The Fast and the Usurious: Putting the Brakes on Auto Lending Abuses*, THE GEORGETOWN LAW JOURNAL, Vol. 108:1257 (2020).

<sup>166</sup> CFPB, CONSUMER VOICES ON AUTOMOBILE FINANCING, (2016); JOINT STAFF REPORT OF THE BUREAU OF ECONOMICS AND BUREAU OF CONSUMER PROTECTION, AUTO BUYER STUDY: LESSONS FROM IN-DEPTH CONSUMER INTERVIEWS AND RELATED RESEARCH (2020), available at <https://www.ftc.gov/system/files/documents/reports/auto-buyer-study-lessons-depth-consumer-interviews-related-research/bcpreportsautobuyerstudy.pdf>

<sup>167</sup> See, e.g., *10 Best Auto Loan Refinancing Lenders of December 2020*, NERDWALLET, "Refinancing an auto loan could lower your rate and monthly payment, saving you hundreds of dollars a year," <https://www.nerdwallet.com/best/loans/auto-loans/refinance-car-loan>.

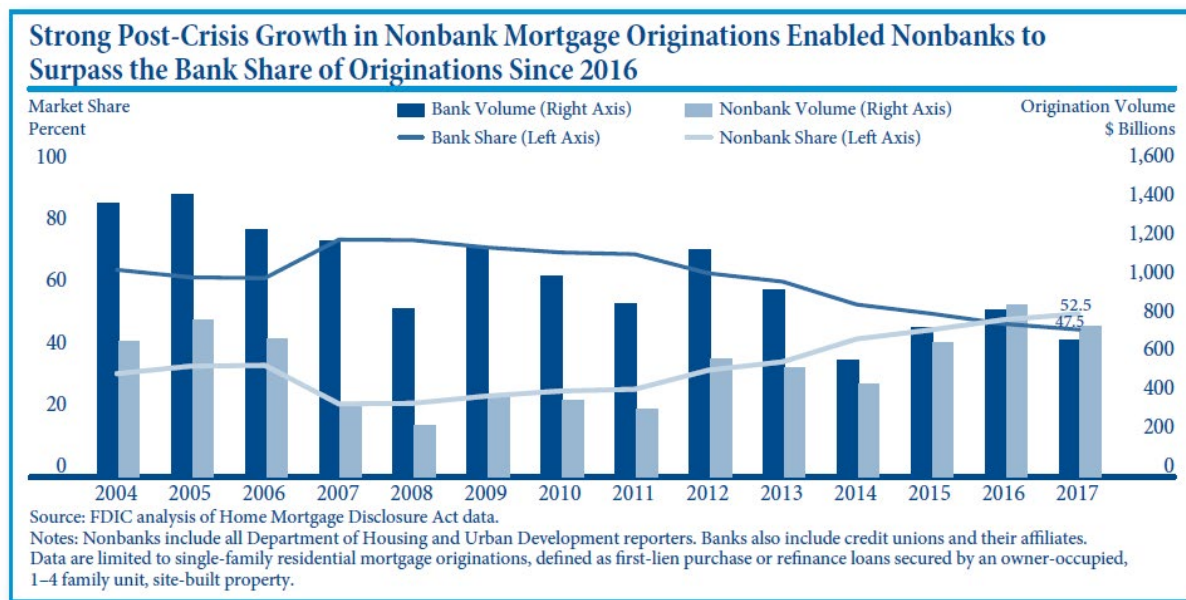
<sup>168</sup> Michael Fratantoni, *Mortgage Market Dynamics: Competition and Evolution*, THE JOURNAL OF STRUCTURED FINANCE, 24 (4) 34-42 (Winter 2019), available at, <https://jsf.pm-research.com/content/24/4/34>.

<sup>169</sup> Dean Amel, Elliot Anenberg, and Rebecca Jorgensen, *On the Geographic Scope of Retail Mortgage Markets*, FEDS NOTES (June 15, 2018)



mortgage market is that nonbank companies have displaced bank sources as the leading lenders. The trends are shown in Figure 8-14, reproduced from an FDIC study, indicating that banks' share of mortgage originations fell from around 70 percent in 2005 to less than 50 percent in 2017.<sup>170</sup>

**FIGURE 8-14:** STRONG POST-CRISIS GROWTH IN NONBANK MORTGAGE ORIGINATIONS ENABLED NONBANKS TO SURPASS THE BANK SHARE OF ORIGINATIONS SINCE 2016



New entrants have been very successful taking shares from incumbents in mortgage markets. This manifestation of competition, according to a report in the FDIC Quarterly, “helped to spur technological innovation beneficial to lenders, servicers, and consumers. Most nonbanks were new to mortgage origination and servicing and built their processes and platforms from the ground up using many technological innovations.”<sup>171</sup>

Annual CFPB Reports track the developments in detail. In 2019, the largest originator of home purchase and refinance loans in the country was an online company, and 15 of the top 25 are independents, which originated more than half the mortgages in the top 25.<sup>172</sup> Eight large banks,

<sup>170</sup> Kayla Shoemaker, Trends in Mortgage Origination and Servicing:

*Nonbanks in the Post-Crisis Period*, FDIC QUARTERLY, Vol 13, No 4, Chart 2, (2019).

<sup>171</sup> Id. at 64.

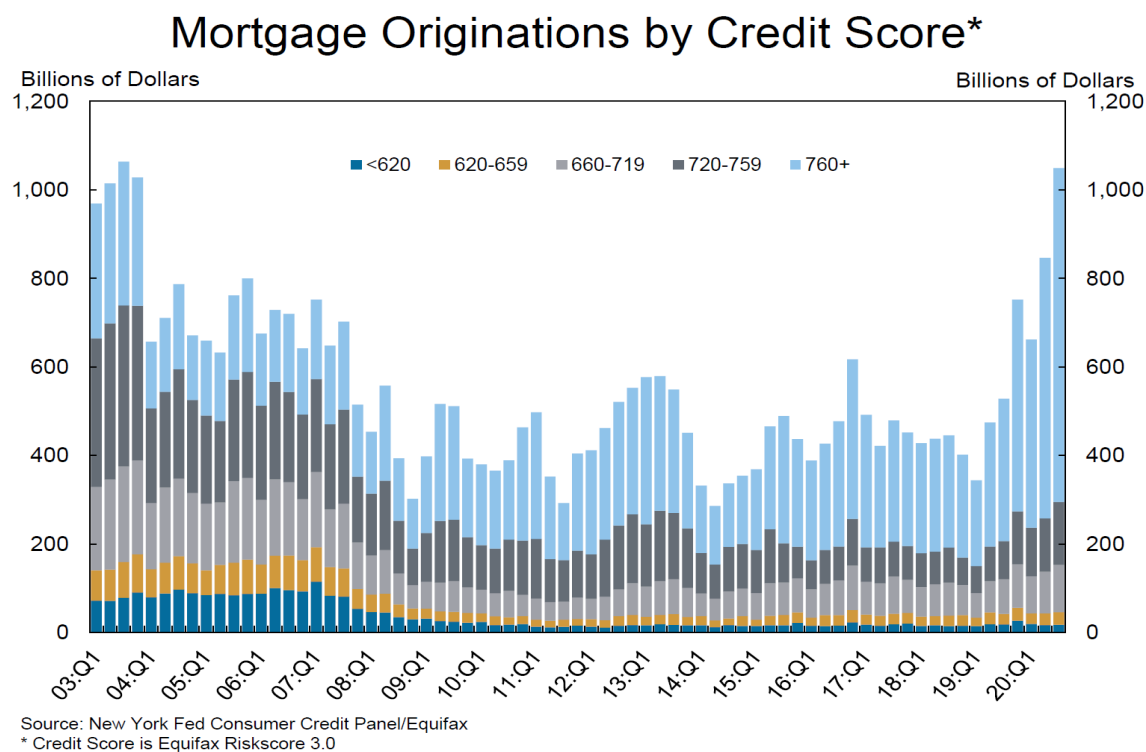
<sup>172</sup> CFPB, DATA POINT: 2019 MORTGAGE MARKET ACTIVITY AND TRENDS, Table 11 (June 24, 2020).



a credit union and an affiliated mortgage company rounded out the top tier. Twenty-five lenders in a national market would suggest a low level of concentration even if they accounted for the entire market; in fact, the top 25 do not account for half of all originations. In short, mortgage lenders compete in a market that appears to be competing vigorously both among institutions and across institutional lines.

In order to benefit from this competition, consumers need to qualify for mortgage loans in the first place. Borrowers with credit scores between 350 and 659 accounted for about \$15 billion in monthly originations at the end of 2018, while borrowers at 660 and above took out \$130 billion a month.<sup>173</sup> Having a credit history that yields a good score is the key that unlocks this market for consumers. Figure 8-15, from the New York Fed, shows originations by credit score since 2003.<sup>174</sup> In recent years, borrowers with scores above 720 account for the vast majority of loans.

**FIGURE 8-15: MORTGAGE ORIGINATIONS BY CREDIT SCORE**



<sup>173</sup> CFPB, *Borrower Risk Profiles*, <https://www.consumerfinance.gov/data-research/consumer-credit-trends/mortgages/borrower-risk-profiles/>.

<sup>174</sup> New York Fed (2020), *supra* note 130.

## 8.4 Services that Consumers Do Not Purchase Directly

A common question about competition is whether consumers can expect to benefit from it if they are not directly deciding which goods or services they acquire. Customers choose their bank or lender, but they do not typically choose the suppliers and agents that their institutions enlist to provide the package of services associated with the savings, payments, and loans. In this respect, the markets for financial services differ little from most other markets. An average automobile, for example, consists of about 30,000 parts from hundreds of suppliers.<sup>175</sup> Consumers choose hardly any parts or suppliers. Instead, auto manufacturers attempt to procure those parts at competitive prices and acceptable quality, and they take advantage of competition to do so. The manufacturer who fails will either absorb higher expenses or pass on the costs and lose customers who can find lower prices and better quality in the showroom of a competitor. Even a monopolist in control of the entire industry would prefer to maximize the margin it can achieve between the costs it incurs and the prices it charges, although more competitive consumer markets intensify the incentive for firms to minimize costs and enhance quality. Thus, the benefits of competition (or the costs of market power) should not be expected to evaporate because customers are not choosing every aspect of the item they are acquiring. This chapter next considers competition in several services that financial firms, rather than consumers, typically buy.

### 8.4.1 Information – Credit Reports and Credit Scores

A consistent theme that runs through the history of credit is the importance of information. For the creditor, information about the borrower governs whether to lend and how much to charge. For the borrower, information about creditors is the catalyst that triggers competition among them.

#### Credit Reports

The Bureau described the functions and importance of the credit reporting industry in a 2012 Review:

In most of the markets for consumer credit, including credit cards, auto loans, mortgages, and student loans, lenders use credit reports as part of their evaluation of a consumer's application for credit. Companies use credit reports and credit scores derived from the information in credit

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<sup>175</sup> Ben Foldy, Auto-Parts Suppliers Teeter as Car Production Halts, Wall Street Journal, April 2, 2020.

reporting files to assess a consumer's likelihood of repaying the loan.... Underwriting processes stipulated by the FHA, VA, Fannie Mae, and Freddie Mac require mortgage lenders to obtain credit reports from a nationwide credit reporting agency (the NCRAs) before these federal agencies and government-sponsored enterprises (GSEs) will insure, guarantee, or purchase their loans. For each of these forms of credit and origination channels, credit reports are used by lenders to help set interest rates and other key credit terms, or determine whether the consumer is offered credit at all. Of 113 million credit card and retail card accounts, auto loans, personal loans, mortgages, and home equity loans originated in the United States in 2011, the vast majority of approval decisions used information furnished by credit reporting agencies.<sup>176</sup>

Before credit reports were widely available and inexpensive, information was a competitive advantage for creditors with repeat business. Merchants were pioneers of credit, thanks to their familiarity with customers. Human relationships help explain the rise of immigrant banks, credit unions, Morris Plan Banks, and other institutions that thrived when commercial banks concentrated on the needs of companies and wealthy clientele. Neighborhood finance companies and pawnbrokers in the early 20th century had similar advantages over the lending societies and larger institutions in city centers.

The advantages of repeat business continue to accrue today. A recent report concluded that payment activity generated roughly 90 percent of banks' useful customer data and advised banks to leverage the information in support of their other businesses.<sup>177</sup> Another study demonstrated that banks can mitigate risk on their customers' credit cards by using information from their other accounts.<sup>178</sup> A banking relationship—with its steady stream of deposits, payments, balances, and other data—generates a wealth of information for a bank that other lenders and card issuers do not have.

Regardless of its relationship with a customer, a lender or merchant will see only a fraction of the economic activity of a prospective borrower, and millions of credit decisions are made

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<sup>176</sup> CFPB, KEY DIMENSIONS AND PROCESSES IN THE U.S. CREDIT REPORTING SYSTEM: A REVIEW OF HOW THE NATION'S LARGEST CREDIT BUREAUS MANAGE CONSUMER DATA (2012), available at [https://files.consumerfinance.gov/f/201212\\_cfpb\\_credit-reporting-white-paper.pdf](https://files.consumerfinance.gov/f/201212_cfpb_credit-reporting-white-paper.pdf).

<sup>177</sup> McKinsey & Company, *Global Payments Report 2019: Amid sustained growth, accelerating challenges demand bold actions* (2019), available at <https://www.mckinsey.com/~media/mckinsey/industries/financial%20services/our%20insights/tracking%20the%20sources%20of%20robust%20payments%20growth%20mckinsey%20global%20payments%20map/global-payments-report-2019-amid-sustained-growth-vf.ashx>

<sup>178</sup> Sumit Agarwal, Souphala Chomsisengphet, Chunlin Liu, Changcheng Song, Nicholas S. Souleles, *Benefits of relationship banking: Evidence from consumer credit markets*, JOURNAL OF MONETARY ECONOMICS Volume 96, Pages 16-32 (June 2018), available at <https://www.sciencedirect.com/science/article/abs/pii/S0304393218300928>.

without the benefit of prior relationships. For these reasons, the demand for information on creditworthiness has supported a thriving market of credit reporting agencies (CRAs) since before the Civil War. Credit reporters, including the predecessors of Dun & Bradstreet, were big businesses in the middle of the 19th century, although their reporting focused on commercial loans.<sup>179</sup> By the 1920s, the expansion of consumer credit generated sufficient demand to support a market for information about them.

By 1972, as the NCCF observed, credit reporting on consumers was also a big business. Indeed, the NCCF worried that providers of credit information might need to be regulated as public utilities, given the costs of computer processing and data storage. The theory was that competition would be no more likely to work in credit reporting than in telephone service; one company per region would be more efficient.<sup>180</sup> Technology proved the NCCF wrong, both for telephones and for credit reports. Advances in processing and reductions in the cost of data have opened opportunities for competition to work in the sector. How well competition has worked is another question that merits consideration.

With respect to the collection and reporting of information, the performance of the sector has generated mixed reviews and numerous complaints. A 2012 FTC study found that 26 percent of consumers surveyed had identified potentially material errors in their credit reports. When the errors were corrected, half of those consumers (13 percent of all surveyed) saw a change in their credit score, and nearly half of the changes were enough to improve the terms they could get for loans.<sup>181</sup> The NCCF conducted a follow-up study in 2015, and it found that two-thirds of the consumers who had disputed information in their reports were still in their disputes. This prompted the recommendation that the CRAs improve their dispute-resolution procedures.<sup>182</sup> At the Bureau, credit and consumer reporting generate the most complaints of any industry, twice as many as debt collectors, and four times as many as credit cards in 2019.<sup>183</sup> CRAs responded to 97 percent of complaints the Bureau forwarded to them in 2019, and about 90

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<sup>179</sup> See Appendix B for more on the origins of credit reporting and competition.

<sup>180</sup> It appears to the Commission that in the long run the credit reporting industry has the ingredients of a public utility. It is as uneconomical to have three credit bureaus in town as it is to have three telephone companies. The necessity for accurate and comprehensive credit data, the technology, the mobility of the population, and the emergence of the multiparty credit card - all argue for a single credit reporting agency for each metropolitan area linked with similar agencies throughout the nation." NCCF (1972), *supra* note 5, at 213.

<sup>181</sup> FTC, *In FTC Study, Five Percent of Consumers Had Errors on Their Credit Reports That Could Result in Less Favorable Terms for Loans*, February 11, 2013, available at <https://www.ftc.gov/news-events/press-releases/2013/02/ftc-study-five-percent-consumers-had-errors-their-credit-reports>

<sup>182</sup> *Id.*

<sup>183</sup> CFPB, CONSUMER RESPONSE ANNUAL REPORT (2019), available at [https://files.consumerfinance.gov/f/documents/cfpb\\_consumer-response-annual-report\\_2019.pdf](https://files.consumerfinance.gov/f/documents/cfpb_consumer-response-annual-report_2019.pdf).

percent of the cases were closed by the end of the year. Consumer lawsuits have resulted in revised reporting practices. For example, CRAs have removed potentially unreliable sources like tax liens, civil judgments, and recent medical bills.<sup>184</sup>

In the context of 1.3 billion monthly tradelines coming in from 10,000 sources and populating files on more than 200 million consumers, the numbers of complaints about inaccuracies may reflect a sector performing well or may reveal room for improvement. Inaccuracies are inevitable in billions of bits of information, and the sheer volume of data means that even a vanishing fraction of errors will add up to large absolute numbers, which could affect millions of reports. It would be impossible to eliminate errors, and this is recognized in federal policy. The Fair Credit Reporting Act (FCRA) anticipated the inevitability of errors and gave consumers the right to discover and correct them. As the FTC studies and Bureau reports show, consumers use the procedures available to them, and the agencies' have pushed for improvements in the accuracy of the data and the procedures to correct mistakes.

More revealing than errors about the state of competition in the sector may be what is missing altogether from these large databases. In 2010, 26 million consumers (11 percent of the adult population) had no credit records at the NCRAs. They were “credit invisible.” An additional 19 million (8.3 percent) had credit files that were too thin to generate a reliable credit score.<sup>185</sup> Missing and thin credit files are more likely to occur among African Americans, Blacks, Hispanics, and consumers living in low-income areas. It well recognized that the so-called “credit invisibles” are engaged in economic activity that generates useful information on creditworthiness, and no doubt many of them are creditworthy. The problem is that much of the information about them is not reaching the NCRAs, so they are not generating reports that could put millions of consumers on the path to better credit.<sup>186</sup> Much of the information in NCRA files comes from a concentrated collection of sources. As of 2012, 10 institutions were furnishing most of the data that each bureau collected, and 60 percent of the information in their files came from retail and network-branded credit cards.<sup>187</sup>

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<sup>184</sup> FDIC, *New Standards for Credit Report Accuracy May Help Consumers*, FDIC CONSUMER NEWS (Winter 2018), available at, <https://www.fdic.gov/consumers/consumer/news/cnwin18/creditreports.html>.

<sup>185</sup> OFFICE OF RESEARCH, CFPB, DATA POINT: CREDIT INVISIBLES (2015), available at [https://files.consumerfinance.gov/f/201505\\_cfpb\\_data-point-credit-invisibles.pdf](https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf). *See chapter 10 for more recent data.*

<sup>186</sup> CFPB *Explores Impact of Alternative Data on Credit Access for Consumers Who Are Credit Invisible*,” (February 16, 2017), available at <https://www.consumerfinance.gov/about-us/newsroom/cfpb-explores-impact-alternative-data-credit-access-consumers-who-are-credit-invisible/>; CFPB, *Becoming credit visible* JUN 07, 2017, available at <https://www.consumerfinance.gov/data-research/research-reports/cfpb-data-point-becoming-credit-visible/>.

<sup>187</sup> CFPB, CREDIT REPORTING WHITE PAPER (2012), available at, [https://files.consumerfinance.gov/f/201212\\_cfpb\\_credit-reporting-white-paper.pdf](https://files.consumerfinance.gov/f/201212_cfpb_credit-reporting-white-paper.pdf).

Untapped information, sometimes called alternative data, appears to be an opportunity that competitors would seize to gain an advantage in the marketplace. More and better information at one CRA would make its reports more valuable to lenders. Indeed, innovation is occurring on this front. Each of the NCRAs has acquired capacity to collect alternative data not typically furnished, such as rental and short-term loan payments.<sup>188</sup> Those data have the potential to build credit histories for consumers who are “invisible” or have thin files with disproportionately negative information.<sup>189</sup> Competition will determine whether collecting better information and offering it to lenders will reward the CRA that does it faster and better than the others. If there is no advantage to the company that outperforms the other, there will be little incentive for any to do so. The question is whether competition will be strong enough to tap the full potential of new sources of information that can open consumer credit markets to new applicants.

The number of competitors at the national level and the way in which reports are purchased suggest that competition is not working as well as it could. Three firms dominate the collection and reporting of traditional consumer information: Experian, Equifax, and TransUnion. For general credit decisions, lenders typically purchase reports on consumers from all three CRAs, diminishing the incentive of one to underbid or outperform the others. Lenders will naturally prefer more reports, since a second or third report about a borrower can be expected to reveal some marginal information that the first one or two did not contain. But because the benefit of that additional information is not likely to be large, the marginal report will command a correspondingly marginal price, and the marginal price will influence the market price since buyers cannot know which report has information missing from another before obtaining them all. On the seller’s side, the expectation that a product will sell, whether or not a customer also buys from the competition, reduces the incentive to offer the best product on most attractive terms.

It is in specialized applications, typically involving expensive transactions, that competition intensifies, because lenders pay premiums to CRAs for reports that are customized to the lenders’ markets. Alternative data that could create distinctions among basic reports may create opportunities for rivalry among CRAs to break out. Those opportunities may have a better chance of realization if the industry and the GSEs consider whether the benefits of tri-merged reports exceed their costs. The Urban Institute has suggested that bi-merge or single-score

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<sup>188</sup> Steven Menendez, *Now wanted by big credit bureaus like Equifax: Your ‘alternative’ data*, FAST COMPANY (April 6, 2019), available at <https://www.fastcompany.com/90318224/now-wanted-by-equifax-and-other-credit-bureaus-your-alternative-data>. .

<sup>189</sup> See Chapter 10.

regimes could enhance competition.<sup>190</sup> That competition could lead to lower prices and improved reports.

## Credit Scores

While the national credit reporting market would be considered highly concentrated, the structure of the market does not approach the concentration that characterizes the provision of credit scores. The dominant provider of credit ratings, Fair Isaac Corporation, boasts that its FICO Score has been used in 90 percent of lending decisions. The company cites a press release from the Mercator Advisory Group,<sup>191</sup> which reported:

New research from Mercator Advisory Group has found that in the United States, FICO® Scores were in 2016 used in more than 90 percent of lending decisions, including credit cards, mortgages, and automobile financing. In addition, Mercator performed a study of the frequency in 2016 and 2017 of FICO Score usage in the securitization process for U.S. asset-backed securities (ABS) backed by automobile leases, credit cards, prime auto loans, and subprime auto loans. *The study found that ABS securitizations in those four verticals almost universally cite the FICO Score.*

A 90 percent share of a market is considered a monopoly. By itself, a monopoly does not suggest a failure of competition, because a dominant firm could be the result of a competition in which it has won its share by dint of superior performance. However, FICO has maintained comparable shares for decades, and dominance of durability does not appear often. It stands in contrast, for example, to the market shares in comparable lines, like the commercial credit ratings services.<sup>192</sup> Moreover, litigation involving Fair Isaac and potential entrants into the credit scoring business casts doubt on the explanation that the company's dominance is based on the superiority of the FICO Score.

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<sup>190</sup> A bi-merge or a single score regime would have two immediate benefits, according to the Institute: “First, such a move would give score providers an incentive to compete for lender business—either through better pricing or superior products and services—and second, the cost of origination could be marginally reduced, as fewer scores would need to be purchased and paid for.” Karan Kaul and Laurie Goodman, *The FHFA’s Evaluation of Credit Scores Misses the Mark*, URBAN INSTITUTE (March 2018, available at [https://www.urban.org/sites/default/files/publication/97086/the\\_fhfas\\_evaluation\\_of\\_credit\\_scores\\_misses\\_the\\_mark\\_0.pdf](https://www.urban.org/sites/default/files/publication/97086/the_fhfas_evaluation_of_credit_scores_misses_the_mark_0.pdf)).

<sup>191</sup> Mercator Advisory Group, *Scores Used in Over 90 of Lending Decisions According to New Study* (February 2018), available at [https://www.mercatoradvisorygroup.com/Press\\_Releases/FICO%C2%AE\\_Scores\\_Used\\_in\\_Over\\_90\\_of\\_Lending\\_Decisions\\_According\\_to\\_New\\_Study/](https://www.mercatoradvisorygroup.com/Press_Releases/FICO%C2%AE_Scores_Used_in_Over_90_of_Lending_Decisions_According_to_New_Study/) (emphasis added)

<sup>192</sup> See, e.g. Staff of the U.S. Securities and Exchange Commission, *Annual Report on Nationally Recognized Statistical Rating Organizations*, (January 2020) at 10, for NSRO volumes in various categories.



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.<sup>193</sup> 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.”<sup>194</sup>

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.<sup>195</sup> 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.<sup>196</sup> 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.<sup>197</sup>

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

<sup>194</sup> Id. at 17 [need F 3d page].

<sup>195</sup> 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;HolmesCountyBankandTrustCompanyv.FairIsaacCorporation,N.D.Ill.Case:1:20-cv-03395,availableathttps://classactionsreporter.com/wp-content/uploads/Fair-Isaac-FICO-Credit-Scores-Antitrust-Compl.pdf>.

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

<sup>197</sup> 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.<sup>198</sup> 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.<sup>199</sup> 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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<sup>198</sup> 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 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).

<sup>199</sup> 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.<sup>200</sup>

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.<sup>201</sup>

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.<sup>202</sup> These costs were \$59 and \$482, respectively,

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

<sup>201</sup> Shoemaker, *supra*, note 170.

<sup>202</sup> 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.”<sup>203</sup> 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.<sup>204</sup> 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,<sup>205</sup> and from government-sponsored entities like Fannie Mae.<sup>206</sup> 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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<sup>203</sup> 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](https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/42_Nonbank_Boom_Lux_Greene.pdf)).

<sup>204</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_2019-servicer-size-mortgage-market_report).

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

<sup>206</sup> 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!”<sup>207</sup> 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.<sup>208</sup> 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<sup>209</sup> 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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<sup>207</sup> 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>.

<sup>208</sup> 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>.

<sup>209</sup> 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.”<sup>210</sup>

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.<sup>211</sup> 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.<sup>212</sup>

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,<sup>213</sup> 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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<sup>210</sup> 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>.

<sup>211</sup> 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](https://files.consumerfinance.gov/f/documents/20160727_cfpb_Third_Party_Debt_Collection_Operations_Study.pdf)

<sup>212</sup> 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>.

<sup>213</sup> 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.<sup>214</sup>

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.<sup>215</sup> 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.<sup>216</sup> In

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<sup>214</sup> 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>.

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

<sup>216</sup> *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.<sup>217</sup>

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."<sup>218</sup> 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."<sup>219</sup> 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.<sup>220</sup>

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

<sup>218</sup> 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>.

<sup>219</sup> *Ohio v. American Express Co.*, 585 U.S. \_\_\_, \_\_ (2018) (The state of Ohio was also a party.)

<sup>220</sup> *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.<sup>221</sup>

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,<sup>222</sup> while Google is reportedly planning new checking account offerings, in partnership with banks, according to "Business Insider."<sup>223</sup> 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.<sup>224</sup>

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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<sup>221</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3556340).

<sup>222</sup> 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>.

<sup>223</sup> 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>

<sup>224</sup> BIS (2019), *supra* note 200, at 55.



of June.”<sup>225</sup> 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.”<sup>226</sup> 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.”<sup>227</sup>

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.<sup>228</sup> The company that

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<sup>225</sup> Yang, Jack Ma’s Ant Group Ramped Up Loans, Exposing Achilles’ Heel of China’s Banking System, WALL STREET JOURNAL, Dec. 6, 2020.

<sup>226</sup> 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).

<sup>227</sup> 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>.

<sup>228</sup> 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.<sup>229</sup> 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

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<sup>229</sup>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.<sup>230</sup>

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.”<sup>231</sup> Similar trends appear in CFPB data, which show Black or African American and Hispanic shares of mortgages up 10 percent overall since 2010.<sup>232</sup> 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.<sup>233</sup> 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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<sup>230</sup> 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](https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf) (including a survey of the literature).

<sup>231</sup> Jennifer Miller, *A Bid to End Loan Bias*, New York Times, September 20, 2020, at Business 4.

<sup>232</sup> CFPB (2019), *supra* note 172.

<sup>233</sup> 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.<sup>234</sup> 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.<sup>235</sup>

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

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<sup>234</sup> Cohen, *Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation*, REVIEW OF LAW AND ECONOMICS (2012).

<sup>235</sup> 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,”<sup>236</sup> and that “markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.”<sup>237</sup> 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

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<sup>236</sup> DFA Section 1021(a) (12 U.S.C. § 5511(a))

<sup>237</sup> 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.<sup>238</sup>

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.

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<sup>238</sup> 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.

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## 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.”<sup>239</sup> 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.”<sup>240</sup> 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.<sup>241</sup>

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

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<sup>239</sup> Jordan, *Women And Credit In Pre-Industrial And Developing Societies*, 12 (1993).

<sup>240</sup> Sidney Homer, Richard Sylla, *A History Of Interest Rates* (2005) Kindle Edition, 772.

<sup>241</sup> 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.<sup>242</sup> 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*.<sup>243</sup> 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

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

<sup>243</sup> "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.<sup>244</sup> 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.<sup>245</sup> 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.”<sup>246</sup> 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.<sup>247</sup>

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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<sup>244</sup> 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.

<sup>245</sup> Id.

<sup>246</sup> Jordan, *Europe in the High Middle Ages*, 17 (2003).

<sup>247</sup> 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.”<sup>248</sup> Prices in the market stalls often beat prices in the shops.<sup>249</sup> Consumers with limited options among the local stores suddenly had an abundance of choices, and they took advantage of it.<sup>250</sup> 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,<sup>251</sup> 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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<sup>248</sup> Mark Cartwright, *Trade in Medieval Europe*, ANCIENT HISTORY ENCYCLOPEDIA, (08 January 2019), available at <https://www.ancient.eu/article/1301/trade-in-medieval-europe/>.

<sup>249</sup> 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

<sup>250</sup> Cartwright, *supra* note 10.

<sup>251</sup> Id.

plenty of precious metals, spices, and fabrics.<sup>252</sup> 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 4<sup>th</sup> century BC<sup>253</sup> 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,<sup>254</sup> 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.”<sup>255</sup> 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.<sup>256</sup>

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.<sup>257</sup> 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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<sup>252</sup> 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).

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

<sup>254</sup> Glenn Story, *The population of ancient Rome*, *ANTIQUITY* 71 (1997): 966-78.

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

<sup>256</sup> Cantor, *supra* note 14, Ch. 26.

<sup>257</sup> *Id.* Ch 11.

remained. Jordan describes the landscape of the tenth century. Towns were “few in number and very small in size.”<sup>258</sup>

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,<sup>259</sup> 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.<sup>260</sup> 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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<sup>258</sup> Jordan, *supra* note 8, 17.

<sup>259</sup> *Id.*

<sup>260</sup> *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 arrears 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.”<sup>261</sup>

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.<sup>262</sup> 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.<sup>263</sup>

Consumer loans were small and short term, typically repaid in a few weeks or months, almost always less than a year.<sup>264</sup> 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.<sup>265</sup>

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<sup>261</sup> Jordan, *supra* note 1 at 15.

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

<sup>263</sup> Cantor, *supra* note 14, Ch. 11.

<sup>264</sup> Id. at Ch. 26.

<sup>265</sup> 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.<sup>266</sup>

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.”<sup>267</sup> Extensions occurred, of course: *prolongations, prorogationes, elongamentia, elongations, and provisiones*. But almost all small loans were repaid in well under a year.<sup>268</sup>

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.<sup>269</sup> 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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<sup>266</sup> Jordan, *supra* note 1 at 26.

<sup>267</sup> Id. (citation omitted).

<sup>268</sup> Id. (citation omitted).

<sup>269</sup> 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.<sup>270</sup> 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.<sup>271</sup> 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.<sup>272</sup>

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

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<sup>270</sup> 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).

<sup>271</sup> Id. at 1387.

<sup>272</sup> 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.<sup>273</sup> 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.<sup>274</sup>

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

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<sup>273</sup> 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.”)

<sup>274</sup> 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.<sup>275</sup>

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.<sup>276</sup> 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.”<sup>277</sup>

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. Schwartz, 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.<sup>278</sup> 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.”<sup>279</sup> 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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<sup>275</sup> Homer and Sylla, *supra* note 2 at 2418.

<sup>276</sup> 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.”)

<sup>277</sup> Homer and Sylla, *supra* note 2.

<sup>278</sup> 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

<sup>279</sup> 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.<sup>280</sup>

An examination of books documenting thousands of sales of 56 colonial merchants found that 98 percent of the recorded transactions were conducted on credit.<sup>281</sup> 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.<sup>282</sup>

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.”<sup>283</sup> 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.”<sup>284</sup>

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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<sup>280</sup> Id. at 154.

<sup>281</sup> Id. at 159. (Only the recorded transactions survive; cash sales were likely underreported may not have been noted.)

<sup>282</sup> Id.

<sup>283</sup> Id. at 155

<sup>284</sup> 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.<sup>285</sup>

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.<sup>286</sup>

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.<sup>287</sup> 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.<sup>288</sup>

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

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<sup>285</sup> Stobart, Howard, *The Routledge Companion to the History of Retailing* (2018).

<sup>286</sup> 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/>.

<sup>287</sup> Id. (reporting occasional examples of higher rates).

<sup>288</sup> 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)<sup>289</sup>

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.<sup>290</sup> By the middle of the 19<sup>th</sup> century, credit in the form of installment payments became a popular

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<sup>289</sup> Homer and Sylla, *supra* note 2 at 5977

<sup>290</sup> 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.<sup>291</sup> 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.<sup>292</sup>

Perhaps no historical episode illustrates the synergy between credit, competition, and economic growth better than the origins of automobile financing. In the early 20<sup>th</sup> 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

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<sup>291</sup> Id. at 5. Of course, to the extent that commercial served the companies financing consumer loans, the banks played an indirect role.

<sup>292</sup> 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.<sup>293</sup> Recognizing the need for more capital to increase capacity (some thirty manufacturers were producing 2,500 motor vehicles a year by 1899),<sup>294</sup> 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.”<sup>295</sup> 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.<sup>296</sup> 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.<sup>297</sup> By then, over 1,600 finance



<sup>293</sup> 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.>

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

<sup>295</sup> 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/>.)

<sup>296</sup> 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/>.

<sup>297</sup> 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.<sup>298</sup> In 1929, an estimated 30 percent of working families (rising to half of nonfarm families) owned cars.<sup>299</sup> Twenty-three million cars were registered in the United States in 1930,<sup>300</sup> when the Census counted 29 million families.<sup>301</sup>

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.<sup>302</sup> 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.<sup>303</sup> 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.<sup>304</sup>

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.<sup>305</sup> 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.

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

<sup>299</sup>Id. at 203.

<sup>300</sup>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).

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

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

<sup>303</sup>Id. at 203.

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

<sup>305</sup>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.<sup>306</sup>

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.<sup>307</sup>

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.<sup>308</sup> 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.<sup>309</sup>

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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<sup>306</sup> Calder, *supra* note 60.

<sup>307</sup> 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).

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

<sup>309</sup> 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.’<sup>310</sup> 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.<sup>311</sup> 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.”<sup>312</sup>

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.<sup>313</sup> Another survey of New York City’s municipal employees that same year found one in three had taken out small loans.<sup>314</sup> Among these lenders were companies that made “salary loans,” the precursors of today’s payday loans:

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<sup>310</sup> 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.

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

<sup>312</sup> 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).

<sup>313</sup> Lendol Calder, *supra* note 60, at 118.

<sup>314</sup> *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.”<sup>315</sup>

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.<sup>316</sup> 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.<sup>317</sup> 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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<sup>315</sup>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.

<sup>316</sup> Calder (1999), *supra* note 60, at 128-132.

<sup>317</sup> *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 20<sup>th</sup> century.<sup>318</sup>

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.<sup>319</sup>

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.<sup>320</sup> 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.<sup>321</sup> Many customers preferred the

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<sup>318</sup> 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)).

<sup>319</sup> 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)).

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

<sup>321</sup> WENDY WOLOSON, *IN HOCK: PAWNING IN AMERICA FROM INDEPENDENCE 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.<sup>322</sup> Yellowpages.com lists over 200 other pawnshops in the City.<sup>323</sup>

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."<sup>324</sup>

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.<sup>325</sup> In 1905, a home economist wrote, "the spending of money, in the majority of cases, falls to the women."<sup>326</sup> They borrowed an estimated 80 percent of the consumer credit extended in 1914, according to a study in a bankers' periodical.<sup>327</sup> 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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<sup>322</sup> See <https://providentloan.com/en/>.

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

<sup>324</sup> Calder (1999), *supra* note 60, at 211.

<sup>325</sup> 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.

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

<sup>327</sup> 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.<sup>328</sup> 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.<sup>329</sup> 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."<sup>330</sup> 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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<sup>328</sup> Id.

<sup>329</sup> 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.>

<sup>330</sup> 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.<sup>331</sup> 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 engulfed 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,<sup>332</sup> 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.<sup>333</sup>

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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<sup>331</sup> 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](https://www.federalreservehistory.org/essays/stock_market_crash_of_1929)

<sup>332</sup> 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.

<sup>333</sup> 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/o8/o5/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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3683219).

loan had less than five months of payments remaining.<sup>334</sup> 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.<sup>335</sup> One report could find only two failures of finance companies in 1930, in contrast to over 800 banks in just two months at yearend.<sup>336</sup> 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.<sup>337</sup> 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.<sup>338</sup> 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....”<sup>339</sup> 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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<sup>334</sup> CALDER (1999), *supra* note 60, at 266.

<sup>335</sup> CALDER (1999), *supra* note 60, at 270 (citing *Business Week*, 11 February 1931, at 14).

<sup>336</sup> CALDER (1999), *supra* note 60, 271.

<sup>337</sup> CALDER (1999), *supra* note 60, at 268.

<sup>338</sup> CALDER (1999), *supra* note 60, at 275 (citing Nugent, *Consumer Credit and Economic Stability* at 110)

<sup>339</sup>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.<sup>340</sup> Between 1929 and 1936 the number of commercial banks making consumer loans more than tripled, from 208 to 685.<sup>341</sup> 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.<sup>342</sup> 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.<sup>343</sup> 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.<sup>344</sup> 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.”<sup>345</sup> 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:

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

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

<sup>342</sup> *Id.* at 283-86.

<sup>343</sup> 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).

<sup>344</sup> *Id.*

<sup>345</sup> 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.<sup>346</sup>

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.”<sup>347</sup> 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.<sup>348</sup> 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.<sup>349</sup>

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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<sup>346</sup> 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](https://www.bancaditalia.it/pubblicazioni/collana-seminari-convegni/2009-0001/1_volume_regolazione.pdf).

<sup>347</sup> 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).

<sup>348</sup> 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).

<sup>349</sup> 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,<sup>350</sup> 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.<sup>351</sup> 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.<sup>352</sup> However, the most common

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<sup>350</sup> Chapter 10 discusses the NCCF's findings in more detail.

<sup>351</sup> 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).

<sup>352</sup> 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<sup>353</sup> 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.<sup>354</sup> 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.<sup>355</sup>

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.<sup>356</sup>

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.<sup>357</sup> 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

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

<sup>354</sup> Id. at 151.

<sup>355</sup> Id.

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

<sup>357</sup> W. E. B. Du Bois, *Black Reconstruction in America* (The Oxford W. E. B. Du Bois) Ch. XIV (1999)

general store.<sup>358</sup> 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.<sup>359</sup> 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.”<sup>360</sup> Restrictive covenants written into deeds prohibited property sales to African Americans. In Chicago as much as 85 percent of the city was off-limits.<sup>361</sup> And merchants – the source of credit for many consumers and the source of jobs for many women – practiced overt discrimination against people of color.<sup>362</sup> 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

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<sup>358</sup> Nier, *supra* note 121 at 153.

<sup>359</sup> United States Census Bureau, *The Great Migration, 1910 to 1970* (September 13, 2012), available at <https://www.census.gov/dataviz/visualizations/o2o/>.

<sup>360</sup> Isabell Wilkerson, *The Long-Lasting Legacy of the Great Migration*, *Smithsonian Magazine*, (September 2016).

<sup>361</sup> *Id.*

<sup>362</sup> Daniel A Graff, *Retail Workers* *ENCYCLOPEDIA OF CHICAGO*, Chicago Historical Society 2005

interaction with the store's predominately white, affluent clientele.”<sup>363</sup> In New York, a retailer who pioneered installment sales of affordable furniture did not advance credit to African Americans.<sup>364</sup> 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.<sup>365</sup> 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 susceptible 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

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<sup>363</sup> 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/>.

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

<sup>365</sup> 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.”<sup>366</sup> The same fate befell a Florentine, Scaglia Tif.<sup>367</sup>

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

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<sup>366</sup> 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).

<sup>367</sup> Id.

<sup>368</sup> Id.

<sup>369</sup> 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](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%.”<sup>370</sup> 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....”<sup>371</sup>

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.<sup>372</sup> 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.’<sup>373</sup>

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.<sup>374</sup> Sovereigns who could share in the proceeds of lending found ways to

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<sup>370</sup> Id.

<sup>371</sup> Id.

<sup>372</sup> Id.

<sup>373</sup> Id. at 14 (citation omitted)

<sup>374</sup> 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.”<sup>375</sup>

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.”<sup>376</sup>

Interest rate caps did not hurt everyone. They could benefit borrowers who qualified for the lowest rates, like lords, kings, and comfortable merchants.<sup>377</sup> 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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<sup>375</sup> Homer and Sylla, *supra* note 2 at ii.

<sup>376</sup> Helmholz, *supra* note 131.

<sup>377</sup> 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.<sup>378</sup> 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 efficiencies. 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.<sup>379</sup>

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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<sup>378</sup> 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/>.

<sup>379</sup> Cantor, *supra* note 14, Ch. 26.

people to struggles between upper and lower classes – the bourgeois and the rag pickers.<sup>380</sup> 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.<sup>381</sup>

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.<sup>382</sup>

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.<sup>383</sup> Monuments to the wealth of the guilds can be seen in the guildhalls preserved as museums in many European cities today.

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<sup>380</sup> Id.

<sup>381</sup> Koyama, *supra* note 128 (citation omitted)

<sup>382</sup> Id.

<sup>383</sup> 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.<sup>384</sup> 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.”<sup>385</sup> 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....”<sup>386</sup>

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.<sup>387</sup> 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.”<sup>388</sup> 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.”<sup>389</sup>

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.<sup>390</sup>

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*,<sup>391</sup> 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

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<sup>384</sup> Adam Smith, *The Wealth of Nations*, (1776) (Cannon Edition, 1965).

<sup>385</sup> *Id.* at 128.

<sup>386</sup> *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.)

<sup>387</sup> *Id.*

<sup>388</sup> Smith, *supra* note 151 at 625.

<sup>389</sup> *Id.*

<sup>390</sup> Cantor, *supra* note 14.

<sup>391</sup> *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."<sup>392</sup> 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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<sup>392</sup> *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.<sup>393</sup> 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.<sup>394</sup> 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.<sup>395</sup> 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.<sup>396</sup> 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.

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

<sup>394</sup> *Addyston Pipe & Steel Co. v. United States*, 175 U.S. 211 (1899)

<sup>395</sup> *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911)

<sup>396</sup> 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.<sup>397</sup> 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.<sup>398</sup>

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.<sup>399</sup>

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

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

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

<sup>399</sup> 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.”<sup>400</sup> As such, those agreements were illegal *per se* (illegal without inquiry of their asserted benefits) when competitors entered them.<sup>401</sup> 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).<sup>402</sup> 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.<sup>403</sup> 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 19<sup>th</sup> 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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<sup>400</sup> *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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<sup>402</sup> 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>

<sup>403</sup> See, Council on Foreign Relations, “Understanding the Libor Scandal,” (2016), available at <https://www.cfr.org/background/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.”<sup>1</sup> 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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<sup>1</sup> 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.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup>

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.<sup>6</sup>

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<sup>2</sup> 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>.

<sup>3</sup> 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](https://www.philadelphiafed.org/-/media/consumer-finance-institute/payment-cards-center/publications/discussion-papers/2002/eftnetworks_042002.pdf?la=en).

<sup>4</sup> *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).

<sup>5</sup> 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](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).

<sup>6</sup> 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.<sup>7</sup>

In 1946, John S. Biggins introduced his innovative "Charg-It" plan at Flatbush National Bank in Brooklyn, New York.<sup>8</sup> 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 6 percent 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.<sup>9</sup>

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

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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>.

<sup>7</sup> 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>.

<sup>8</sup> LOUIS HYMAN, *DEBTOR NATION: THE HISTORY OF AMERICA IN RED INK* 146-47 (2012).

<sup>9</sup> *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.<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup>

### 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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<sup>10</sup> See, e.g., Fair Credit Billing Act, 15 U.S.C. §§ 1666-1666j.

<sup>11</sup> Credit Card Accountability, Responsibility, and Disclosure Act of 2009, Pub. L. No. 111-24, 23 Stat. 1734 (2009).

<sup>12</sup> 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.<sup>13</sup> Carmax adopted a similar policy in the used car markets, and some other dealers have since followed suit.

### 9.1.4 Autodialers 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<sup>14</sup>, 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.<sup>15</sup> 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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<sup>13</sup> 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*, AUTOMOTIVE 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).

<sup>14</sup> 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).

<sup>15</sup> Fed. Comm’n. 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.<sup>16</sup> 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,<sup>17</sup> 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.

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<sup>16</sup> 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.*

<sup>17</sup> 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."<sup>18</sup> 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.<sup>19</sup>

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.<sup>20</sup> The E-Sign Act further requires that

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<sup>18</sup> S. Rep. No. 106-131, at 1-2 (1999).

<sup>19</sup> Pub. L. No. 106-229 (June 30, 2000), *codified at* 15 U.S.C. § 7001 *et seq.*

<sup>20</sup> 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."<sup>21</sup>

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,<sup>22</sup> 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,<sup>23</sup> which could take an average person 2 to 8 minutes to read or an institution's employee 6 to 10 minutes to recite aloud.<sup>24</sup> 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.<sup>25</sup> 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

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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).

<sup>21</sup> *Id.*

<sup>22</sup> E-Sign Act section 104(b)(2)(B), (c)(1); 15 U.S.C. § 7004(b)(2)(B), (c)(1).

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

<sup>24</sup> 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/>.

<sup>25</sup> See Chapter 7 (Information and Disclosure).

been such a demonstration.<sup>26</sup> 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."<sup>27</sup> 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."<sup>28</sup> 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.<sup>29</sup> 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.<sup>30</sup> 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,

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<sup>26</sup> 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 E-SIGN "Consent Handshake" Standards?* (May 2014), <https://www.counselorlibrary.com/insights/article.cfm?articleID=810>.

<sup>27</sup> E-Sign Act section 101(c)(1); 15 U.S.C. § 7001(c)(1).

<sup>28</sup> 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.").

<sup>29</sup> Compare 12 C.F.R. § 1026.5(a)(1)(iii) (open-end loans) with 12 C.F.R. § 1026.41(c) (closed-end loans).

<sup>30</sup> 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.<sup>31</sup> 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.<sup>32</sup>

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.<sup>33</sup> 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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<sup>31</sup> 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).

<sup>32</sup> Bureau of Consumer Fin. Protect., *Debt Collection Practices (Regulation F)*, \_\_ FED. REG. \_\_, Docket No. CFPB-2019-002, Oct. 30, 2020, at 432-42.

<sup>33</sup> 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.<sup>34</sup> 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.<sup>35</sup> 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,<sup>36</sup> and still others holding that no voicemail is completely immune from liability. Risk-averse collectors could simply choose not to leave them.<sup>37</sup>

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.<sup>38</sup> The Bureau has recently finalized a rule that would enable collectors to leave voicemails limited to specific content.<sup>39</sup>

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.<sup>40</sup> By the proposed rule stage, however, the Bureau

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

<sup>35</sup> 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).

<sup>36</sup> 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).

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

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

<sup>39</sup> 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)).

<sup>40</sup> 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](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.<sup>41</sup> 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 as extending the existing regulatory regime to cover new products and services (raising rivals’ entry costs or preventing entry altogether).<sup>42</sup>

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

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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.”).

<sup>41</sup> 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)).

<sup>42</sup> 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](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.<sup>43</sup> 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.<sup>44</sup> 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.<sup>45</sup>

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.<sup>46</sup>

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

<sup>44</sup> 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](https://www.cftc.gov/sites/default/files/2018-09/labcftc_officehours102318.pdf).

<sup>45</sup> UNGSA, *supra* note 42, at 21, figure 6.

<sup>46</sup> *Id.* at 21.

The Bureau established its Office of Innovation in 2018, folding into it the work of a predecessor endeavor.<sup>47</sup> 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.<sup>48</sup> “[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.”<sup>49</sup> 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.<sup>50</sup> 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.<sup>51</sup>

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.<sup>52</sup> For example, the Bank Negara Malaysia amended its “know your customer” regulations after a

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<sup>47</sup> 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/>.

<sup>48</sup> UNGSA, *supra* note 42, at 7.

<sup>49</sup> *Id.* at 26.

<sup>50</sup> *Id.* at 27.

<sup>51</sup> *Id.*

<sup>52</sup> 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.<sup>53</sup>

As of late 2020, the Bureau has two sandbox programs dedicated to innovation—a Compliance Assistance Sandbox (CAS) and a Trial Disclosure Sandbox.<sup>54</sup> 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.<sup>55</sup> Bureau approvals are “intended to facilitate compliance in the face of regulatory uncertainty.”<sup>56</sup> 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)<sup>57</sup>—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.<sup>58</sup>

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.”<sup>59</sup> If the reported information, or

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<sup>53</sup> 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>.

<sup>54</sup> 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/>.

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

<sup>56</sup> CAS Policy, 84 FED. REG. at 42848.

<sup>57</sup> 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.

<sup>58</sup> CFPB CAS Policy, 84 Fed. Reg. at 48247, § E.1.

<sup>59</sup> *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.<sup>60</sup>

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.<sup>61</sup> 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.<sup>62</sup> 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.<sup>63</sup> To that extent, the Bureau has stated that CAS approvals are meant to address regulatory uncertainty, not to relieve entities from regulatory obligations.<sup>64</sup>

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.<sup>65</sup> 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

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<sup>60</sup> *Id.*, § E.3.

<sup>61</sup> *Id.*, § F.

<sup>62</sup> 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.

<sup>63</sup> *Id.*, §§ B.5, C.

<sup>64</sup> 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.").

<sup>65</sup> 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.<sup>66</sup> 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.<sup>67</sup> 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.<sup>68</sup> 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

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

<sup>67</sup> 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>.

<sup>68</sup> 12 U.S.C. § 5532(e).

revised substantially in 2019, though it has yet to approve an application under either policy.<sup>69</sup> 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.<sup>70</sup> 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.<sup>71</sup> They can also offer economies of scale to multiple regulators operating the sandbox together, though initial start-up costs and coordination may be challenging.<sup>72</sup> For financial entities, they offer the opportunity to testing products or strategies in multiple states or countries at once.<sup>73</sup>

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.<sup>74</sup> 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.<sup>75</sup> 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

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<sup>69</sup> 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"].

<sup>70</sup> CFPB 2019 Trial Disclosure Policy, 84 FED. REG. at 48261 n.4.

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

<sup>72</sup> UNGSA, *supra* note 42, at 28.

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

<sup>74</sup> Am. Consumer Fin. Innovation Network, *Charter as of October 15, 2019*, [https://files.consumerfinance.gov/f/documents/201910\\_cfpb\\_ACFIN-charter.pdf](https://files.consumerfinance.gov/f/documents/201910_cfpb_ACFIN-charter.pdf).

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

and services.”<sup>76</sup> 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.<sup>77</sup> 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.<sup>78</sup>

The Bureau also participates in the Global Financial Innovation Network (GFIN), one of the two international sandboxes.<sup>79</sup> 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.<sup>80</sup> 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.<sup>81</sup> 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.<sup>82</sup>

### 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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<sup>76</sup> Am. Consumer Fin. Innovation Network, *Charter as of October 15, 2019*, [https://files.consumerfinance.gov/f/documents/201910\\_cfpb\\_ACFIN-charter.pdf](https://files.consumerfinance.gov/f/documents/201910_cfpb_ACFIN-charter.pdf).

<sup>77</sup> 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/>.

<sup>78</sup> Am. Consumer Fin. Innovation Network, *Charter as of October 15, 2019*, [https://files.consumerfinance.gov/f/documents/201910\\_cfpb\\_ACFIN-charter.pdf](https://files.consumerfinance.gov/f/documents/201910_cfpb_ACFIN-charter.pdf).

<sup>79</sup> 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.*

<sup>80</sup> Global Fin. Innovation Network, <https://www.thegfin.com/>.

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

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

description of a proposed transaction, product, or service.<sup>83</sup> 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.<sup>84</sup> 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.<sup>85</sup>

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.<sup>86</sup> 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.<sup>87</sup> By some estimates, the SEC has issued over 2,500 no-action letters in the last 50 years.<sup>88</sup> The Commodity Futures Trading Commission (CFTC) has likewise made extensive use of no-action letters, issuing at least an estimated 1,500 since 1975.<sup>89</sup> Similar to the SEC's

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<sup>83</sup> 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).

<sup>84</sup> 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).

<sup>85</sup> 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.>").

<sup>86</sup> 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)).

<sup>87</sup> 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).

<sup>88</sup> 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"].

<sup>89</sup> 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.<sup>90</sup>

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”<sup>91</sup> and “the sole body of precedent” on some aspects of securities law.<sup>92</sup> Issued without 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.<sup>93</sup> 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

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<sup>90</sup> 17 C.F.R. § 140.99(a)(2).

<sup>91</sup> Nagy, 83 CORNELL L. REV. at 925.

<sup>92</sup> 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)l Fed. Sec. L. Rep. (CCH) ¶ 84,228, at 89,053, 89,054 (Apr. 7, 1988)).

<sup>93</sup> 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.<sup>94</sup> 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.<sup>95</sup>

The Bureau established a no-action letter policy in 2016 and revised it substantially in 2019.<sup>96</sup> Both policies stated that their primary purpose was to promote innovation by reducing regulatory uncertainty as to the use of new technologies or products.<sup>97</sup> 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.<sup>98</sup>

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.<sup>99</sup> Second, unlike the expected two-year terms for sandbox trials, no-action letters are not limited to a two year term.<sup>100</sup> 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.<sup>101</sup> The first, issued under the Bureau’s original 2016 policy, concerned a company that uses alternative data and machine

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<sup>94</sup> 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).

<sup>95</sup> 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).

<sup>96</sup> 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.

<sup>97</sup> CFPB 2016 NAL Policy, 81 FED. REG. at 8688; CFPB 2019 NAL Policy, 84 FED. REG. at 48229.

<sup>98</sup> Id., §§ B, C, and E.

<sup>99</sup> Id., § C.3.

<sup>100</sup> Id., § D.

<sup>101</sup> 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.<sup>102</sup> 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.<sup>103</sup> 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

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<sup>102</sup> 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/>.

<sup>103</sup> 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.<sup>104</sup> 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.<sup>105</sup> The U.K.’s Financial Conduct Authority (FCA) pioneered the use of tech sprints in consumer finance, hosting at least seven since 2016.<sup>106</sup> 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.<sup>107</sup> 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.<sup>108</sup>

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

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

<sup>105</sup> 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>.

<sup>106</sup> 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”].

<sup>107</sup> *Id.*, at § 2.2.

<sup>108</sup> *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.<sup>109</sup>

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.<sup>110</sup> 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.<sup>111</sup> FCA’s tech sprints have also led to literature contributions.<sup>112</sup>

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.<sup>113</sup> Multiple products that participants developed are now available for public use.<sup>114</sup> 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,<sup>115</sup> the Bureau held its first tech sprint in October 2020.<sup>116</sup> 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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<sup>109</sup> Id., at § 2.11.

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

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

<sup>112</sup> 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/>.

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

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

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

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

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

### 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.<sup>120</sup> Agencies have used these methods to promote innovation, with notable examples including the Bureau's policy statement on data sharing<sup>121</sup> and an interagency guidance on the use of alternative data and AI,<sup>122</sup> and a blog post on providing adverse action notices when using AI/machine learning models.<sup>123</sup> 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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<sup>117</sup> 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/>.

<sup>118</sup> *Id.*

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

<sup>120</sup> *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).

<sup>121</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_consumer-protection-principles_data-aggregation.pdf).

<sup>122</sup> *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](https://files.consumerfinance.gov/f/documents/cfpb_interagency-statement_alternative-data.pdf).

<sup>123</sup> <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.<sup>124</sup> 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.<sup>125</sup>

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.<sup>126</sup> 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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<sup>124</sup> 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.”].

<sup>125</sup> *Id.*, at 17 (internal citations omitted).

<sup>126</sup> *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.<sup>127</sup>

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.”<sup>128</sup> 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).<sup>129</sup> 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.<sup>130</sup>

## 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.<sup>131</sup> Some of these service providers use their own technology to access and gather the data, while others hire third parties to obtain the data.<sup>132</sup>

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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<sup>127</sup> 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](https://www.ey.com/en_gl/financial-services/eight-ways-fintech-adoption-remains-on-the-rise).

<sup>128</sup> Treasury FinTech Report, *supra* note 124, at 21-22.

<sup>129</sup> *Id.* (citing Fed. Comm’n Comm’n, *2018 Broadband Deployment Report* (Feb. 2, 2018), [https://apps.fcc.gov/edocs\\_public/attachmatch/FCC-18-10A1.pdf](https://apps.fcc.gov/edocs_public/attachmatch/FCC-18-10A1.pdf)).

<sup>130</sup> 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/>.

<sup>131</sup> 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#>.

<sup>132</sup> 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.<sup>133</sup> 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.<sup>134</sup> 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.<sup>135</sup>

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.<sup>136</sup> 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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<sup>133</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_consumer-protection-principles_data-aggregation.pdf) [hereinafter “CFPB Data Sharing Principles”].

<sup>134</sup> 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).

<sup>135</sup> 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](http://www.prnewswire.com/news-releases/envestnet-yodlee-unveils-personal-financial-wellness-solution-powered-by-data-intelligence-300472018.htm)).

<sup>136</sup> 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.<sup>137</sup>

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.<sup>138</sup> More broadly, some consortiums of market participants, as well as foreign jurisdictions, have developed industry standards and best practices for sharing data.<sup>139</sup>

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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<sup>137</sup> 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).

<sup>138</sup> 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/>.

<sup>139</sup> 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.<sup>140</sup>

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.<sup>141</sup> 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.”<sup>142</sup>

An API is a structured data feed that connects the account holder, such as the consumer’s bank, to the data aggregator.<sup>143</sup> 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

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<sup>140</sup> CFPB Data Sharing RFI, *supra* note 132, 83808-09.

<sup>141</sup> CFPB Data Sharing RFI, *supra* note 132, 83808-09.

<sup>142</sup> 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>.

<sup>143</sup> 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.”<sup>144</sup> 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.<sup>145</sup> 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.<sup>146</sup> 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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<sup>144</sup> Treasury FinTech Report, *supra* note 124, at 53.

<sup>145</sup> 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>).

<sup>146</sup> 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.<sup>147</sup> 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.”<sup>148</sup> 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 countries, 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.<sup>149</sup>

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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<sup>147</sup> 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.”).

<sup>148</sup> UNGSA, *supra* note 42, at 11.

<sup>149</sup> *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](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.<sup>150</sup> 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.<sup>151</sup> 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.<sup>152</sup> 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.<sup>153</sup>

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.<sup>154</sup> 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.<sup>155</sup>

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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<sup>150</sup> *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](https://www.safaricom.co.ke/images/Downloads/Resources_Downloads/HY2019/HY2019_Results_Presentation.pdf)).

<sup>151</sup> *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>).

<sup>152</sup> *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>).

<sup>153</sup> *Id.*

<sup>154</sup> 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](https://www.brookings.edu/wp-content/uploads/2019/06/ES_20190620_Klein_ChinaPayments.pdf).

<sup>155</sup> *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.<sup>156</sup> 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.”<sup>157</sup> 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.<sup>158</sup>

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.<sup>159</sup> 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 registered users. Consumers can hold funds in their accounts or add or withdraw funds from external sources such as a bank account or credit card.<sup>160</sup>

## **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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<sup>156</sup> Treasury FinTech Report, *supra* note 124, at 159.

<sup>157</sup> *Id.*

<sup>158</sup> Aaron Klein (2019), *supra* note 154, at 19.

<sup>159</sup> 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/>.

<sup>160</sup> 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.<sup>161</sup>

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

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<sup>161</sup> Bureau of Consumer Fin. Protect., *Data Point: Credit Invisibles*, at 6 (2015), [https://files.consumerfinance.gov/f/201505\\_cfpb\\_data-point-credit-invisibles.pdf](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 datasets 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.<sup>151</sup> 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.<sup>162</sup> 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.<sup>163</sup> 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

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<sup>162</sup> 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](https://www.experian.com/assets/consumer-information/reports/Experian_Aite_AltDataReport_Final_120418.pdf?elqTrackId=7714eff9f5204e7ca8517e8966438157&elqaid=3910&elqat=2).

<sup>163</sup> 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.<sup>164</sup> 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.<sup>165</sup> These borrowers tend to be disproportionately protected classes.<sup>166</sup> 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.<sup>167</sup> 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 occurs 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.<sup>168</sup> Unlike traditional lenders, marketplace lenders operate largely or entirely online, taking credit applications through their websites or mobile

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

<sup>165</sup> 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>.

<sup>166</sup> 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](https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf).

<sup>167</sup> 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/>.

<sup>168</sup> 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.<sup>169</sup> 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.<sup>170</sup>

### 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.<sup>171</sup> 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.<sup>172</sup> Existing applications also can automatically move a consumer's money between accounts to avoid overdraft fees.

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<sup>169</sup> Treasury FinTech Report, *supra* note 124, at 85.

<sup>170</sup> UNGSA, *supra* note 42, at 12.

<sup>171</sup> *Id.* at 13.

<sup>172</sup> *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.<sup>173</sup> 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.<sup>174</sup> 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

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<sup>173</sup> 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>.

<sup>174</sup> 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.<sup>175</sup> 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.<sup>176</sup>

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.”<sup>177</sup>

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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<sup>175</sup> Id. at 63-64.

<sup>176</sup> 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.

<sup>177</sup> Treasury FinTech Report, *supra* note 124, at 66.

developments in each state.<sup>178</sup> These costs, many of which are relatively fixed, can be most burdensome for small companies or potential new market participants.<sup>179</sup> Differences in state laws can also require firms to vary material attributes of their products or services depending on the applicable law.<sup>180</sup> 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.<sup>181</sup> 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.<sup>182</sup> 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.<sup>183</sup> First, federal chartering could lift the “oppressive restraint[]” of low ceilings on loan sizes, which increased costs to consumers

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<sup>178</sup> 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).

<sup>179</sup> Knight (2013), *supra* note 178, at 112-113.

<sup>180</sup> Treasury FinTech Report, *supra* note 124, at 65.

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

<sup>182</sup> NCCF (1972), *supra* note 181, at 163.

<sup>183</sup> NCCF (1972), *supra* note 181, at 163.

by requiring them to take out multiple smaller loans instead of one larger loan.<sup>184</sup> 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.<sup>185</sup>

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.<sup>186</sup>

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

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<sup>184</sup> NCCF (1972), *supra* note 181, at 163.

<sup>185</sup> NCCF (1972), *supra* note 181, at 164.

<sup>186</sup> NCCF (1972), *supra* note 181, at 165.

supervise for compliance with both state and federal laws, to dividing responsibilities between federal and state examiners.<sup>187</sup>

### 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.<sup>188</sup> There are numerous specific frameworks one could consider,<sup>189</sup> 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.<sup>190</sup> 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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<sup>187</sup> NCCF (1972), *supra* note 181, at 165-67.

<sup>188</sup> 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.").

<sup>189</sup> 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>.

<sup>190</sup> 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.<sup>191</sup> 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.<sup>192</sup> 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.<sup>193</sup>

The OCC has encountered legal obstacles,<sup>194</sup> 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.<sup>195</sup> 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.<sup>196</sup> Some industry members have also questioned whether the OCC's expertise in some areas, such

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<sup>191</sup> *Id.*

<sup>192</sup> *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978).

<sup>193</sup> 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>.

<sup>194</sup> *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).

<sup>195</sup> Treasury FinTech Report, *supra* note 124, at 65-66 ("Banks face their own regulatory regimes, which are quite extensive and can impede innovation.").

<sup>196</sup> 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.<sup>197</sup> 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,<sup>198</sup> 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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<sup>197</sup> 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>.

<sup>198</sup> 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,<sup>199</sup> 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.<sup>200</sup> 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.<sup>201</sup>

#### **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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<sup>199</sup> Bureau of Consumer Fin. Protect., *Consumer Access to Financial Records*, 85 FED. REG. 71003 (Nov. 6, 2020).

<sup>200</sup> 15 U.S.C. § 5533.

<sup>201</sup> *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.<sup>202</sup>

Stakeholders have also highlighted concerns that data aggregators’ user agreements are often unclear or silent about how consumers can opt of data collection.<sup>203</sup> 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.<sup>204</sup>

Other regulators, including the Financial Crimes Enforcement Network and FINRA, have noted that some criminals are using FinTechs to initiate fraudulent transactions.<sup>205</sup>

#### **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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<sup>202</sup> 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>.

<sup>203</sup> 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/>.

<sup>204</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_bureau-symposium-consumer-access-financial-records_report.pdf).

<sup>205</sup> 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.<sup>206</sup> 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.<sup>207</sup> TILA, as implemented by Regulation Z, does the same for unauthorized credit card use.<sup>208</sup> 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.<sup>209</sup> 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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<sup>206</sup> 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).

<sup>207</sup> EFTA section 909(a); 15 U.S.C. § 1693g(a); 12 C.F.R. § 1005.6(b)(2).

<sup>208</sup> TILA section 133; 15 U.S.C. § 1643; 12 C.F.R. § 1026.12(b).

<sup>209</sup> See, *e.g.*, Bureau of Consumer Fin. Protect., File No. 2016-CFPB-0007 (Dwolla, Inc.), [http://files.consumerfinance.gov/f/201603\\_cfpb\\_consentsorder-dwolla-inc.pdf](http://files.consumerfinance.gov/f/201603_cfpb_consentsorder-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.”<sup>210</sup> 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.”<sup>211</sup>

In a supportive jurisdiction, regulators take steps to facilitate open banking without mandating it.<sup>212</sup> 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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<sup>210</sup> 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.*

<sup>211</sup> Leong (2020), *supra* note 210, at 1.

<sup>212</sup> Leong (2020), *supra* note 210, at 3.

regulations.<sup>213</sup> 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.<sup>214</sup> 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.<sup>215</sup>

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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<sup>213</sup> Id.; Treasury FinTech Report, *supra* note 124, at 34.

<sup>214</sup> 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.

<sup>215</sup> 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 limit 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 Carrillo), <https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-carrillo-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.<sup>216</sup> 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.<sup>217</sup>

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.<sup>218</sup> Users of consumer reports must provide notice to the consumer when they take adverse action based on information in a consumer report.<sup>219</sup> And consumers have the right to dispute errors in their credit files with either a CRA or the party that furnished the information.<sup>220</sup>

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 properly or tested sufficiently.<sup>221</sup> Intuitively, financial data would

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<sup>216</sup> 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/uqbH3EPcmILf4T4S4dQmGg2>.

<sup>217</sup> 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>.

<sup>218</sup> FCRA section 607(b) (15 U.S.C. § 1681e(b)).

<sup>219</sup> FCRA section 615(a) (15 U.S.C. § 1681m(a)).

<sup>220</sup> FCRA section 611(a) (15 U.S.C. § 1681i(a)); 12 C.F.R. § 1022.43.

<sup>221</sup> 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.<sup>222</sup> 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.<sup>223</sup> 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.<sup>224</sup> 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.<sup>225</sup>

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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>.

<sup>222</sup> See Section IV.B.2. of this Chapter.

<sup>223</sup> 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>.

<sup>224</sup> 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/](https://www.americanbar.org/groups/business_law/publications/blt/2019/08/alt-lending-models/).

<sup>225</sup> 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.<sup>226</sup> 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.”<sup>227</sup>

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.<sup>228</sup> Some types of data might simultaneously provide useful information about credit risk but could disproportionately 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.<sup>229</sup>

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.<sup>230</sup> 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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<sup>226</sup> 15 U.S.C. § 1691(a).

<sup>227</sup> 12 C.F.R. part 1002, comment 1002.6(a)-2.

<sup>228</sup> 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>.

<sup>229</sup> See e.g. *Id.*

<sup>230</sup> 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/uqbH3EPcmILf4T4S4dQmGg2>.



require significant amounts of data would generally suffer from the absence of past credit-cycle data to ‘train’ the model.”<sup>231</sup>

Some experts warn that the complexity of machine learning-based algorithms may mask their reliance on proxies that are highly correlated with protected classes.<sup>232</sup> 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.”<sup>233</sup> 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.<sup>234</sup> 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.<sup>235</sup> 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.<sup>236</sup> And market participants such as IBM and Microsoft have

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<sup>231</sup> Treasury FinTech Report, *supra* note 124, at 137.

<sup>232</sup> 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>.

<sup>233</sup> Schwarcz & Prince, 105 IOWA. L. REV. at 1274.

<sup>234</sup> Schwarcz & Prince, 105 IOWA. L. REV. at 1273, 1276.

<sup>235</sup> 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/](https://www.americanbar.org/groups/business_law/publications/blt/2019/08/alt-lending-models/).

<sup>236</sup> 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.<sup>237</sup> 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.

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able to 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.

<sup>237</sup> 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](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.”<sup>1</sup>

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.<sup>2</sup> 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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<sup>1</sup> Lewis Mandell, *The Credit Card Industry: A History* at xi (1990).

<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> Moreover, many rural areas still have limited and expensive internet access and may lack reliable mobile phone service.<sup>5</sup> 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.<sup>6</sup> 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

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<sup>3</sup> See Bureau of Consumer Financial Protection Office of Research, Data Point: the Geography of Credit Invisibility (Sept. 2018).

<sup>4</sup> 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.

<sup>5</sup> Id.

<sup>6</sup> 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.”<sup>7</sup> 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.”<sup>8</sup>

### 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:<sup>9</sup>

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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<sup>7</sup> 12 U.S.C. §5511(b).

<sup>8</sup> 12 U.S.C. §5512(b)(2)A(i).

<sup>9</sup> 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.<sup>10</sup> 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

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<sup>10</sup> 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”).

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.”<sup>11</sup> 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.<sup>12</sup>

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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<sup>11</sup> 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.*

<sup>12</sup> 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.”<sup>13</sup>

## 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.<sup>14</sup>

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.<sup>15</sup>

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<sup>13</sup> 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\(AD\)%20has%20become,in%20the%20consumer%20ofinance%20industry.&text=Using%20data%20obtained%20from%20these,the%20quality%20of%20financial%20inclusion.](https://aisel.aisnet.org/icis2019/blockchain_FinTech/blockchain_FinTech/20/#:~:text=Artificial%20intelligence%20(AD)%20has%20become,in%20the%20consumer%20ofinance%20industry.&text=Using%20data%20obtained%20from%20these,the%20quality%20of%20financial%20inclusion.)

<sup>14</sup> See discussion in Newton, *supra* note 10, at 51 (describing prevailing stereotypes of the economic behavior of lower-income individuals).

<sup>15</sup> 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,<sup>16</sup> 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.”<sup>17</sup> As installment selling spread to cover new products and providers beginning in the late-19<sup>th</sup> century, it also “spread extensively among marginalized groups.”<sup>18</sup> As ordinary Americans gained greater access to credit, “retail installment credit ceased being a novelty and became something of a disgrace.”<sup>19</sup> 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.”<sup>20</sup> Animosity toward those providing credit to previously-excluded consumers was often tinged with anti-Semitism and claims that lenders were exploiting vulnerable consumers.<sup>21</sup>

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 20th century, 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

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<sup>16</sup> Edwin R.A. Seligman, 1 *The Economics of Instalment Selling: A Study in Consumers' Credit, with Special Reference to the Automobile* 42 (1927).

<sup>17</sup> Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit* 166 (2001).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> 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 Louis 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.”<sup>22</sup> 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.”<sup>23</sup> 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.<sup>24</sup>

## 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.”<sup>25</sup> 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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<sup>22</sup> Federal Reserve Chairman Alan Greenspan, *Consumer Credit and Financial Modernization* (Oct 11, 1997), available in <https://www.federalreserve.gov/boarddocs/speeches/1997/19971011.htm>.

<sup>23</sup> *Id.*; see also NCCF Report, *supra* note 2, at 46 (noting that in the early 20<sup>th</sup> 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”).

<sup>24</sup> J.A. Reichart, *The Loan Shark Still Flourishes*, 3 Brooklyn Chamber of Commerce Bulletin 9 (July 1, 1922) (reprinted from *Forbes’ Magazine*).

<sup>25</sup> 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).<sup>26</sup> 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,<sup>27</sup> and has recently been reaffirmed,<sup>28</sup> 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.<sup>29</sup> 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.<sup>30</sup>

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<sup>26</sup> See Todd J. Zywicki, *The Market for Information and Credit Card Regulation*, 28 Banking and Fin. Serv. Pol’y Report 13 (Vol. 1, 2009).

<sup>27</sup> NCCF Report, *supra* note 2, at 96-99.

<sup>28</sup> 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).

<sup>29</sup> NCCF Report, *supra* note 2, at 99.

<sup>30</sup> 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.<sup>31</sup> 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 respond by assessing annual fees on cards.<sup>32</sup> 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.<sup>33</sup> 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.<sup>34</sup> 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.

<sup>31</sup> 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](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).

<sup>32</sup> Todd J. Zywicki, *The Economics of Credit Cards*, 3 Chapman L. Rev. 79 (2000).

<sup>33</sup> 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).

<sup>34</sup> 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.<sup>35</sup> 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.<sup>36</sup> 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.<sup>37</sup>

## 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.<sup>38</sup> 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.<sup>39</sup> 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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<sup>35</sup> See William J. Boyes, *In Defense of the Downtrodden: Usury Laws*, 39 Pub. Choice 269 (1982).

<sup>36</sup> See Efraim Benmelech and Tobias J. Moskowitz, The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19<sup>th</sup> Century, 65 J. of Finance 1029 (2010).

<sup>37</sup> See Boyes, *supra* note 35.

<sup>38</sup> 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).

<sup>39</sup> 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.<sup>40</sup> 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.<sup>41</sup> Moreover, retailers typically did not limit price increases to products usually sold on credit but increased the prices on all goods.<sup>42</sup> 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.<sup>43</sup>

A 1979 study by Dunkelberg and DeMagistris illustrated the product substitution response to state usury ceilings.<sup>44</sup> 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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<sup>40</sup> 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).

<sup>41</sup> 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.

<sup>42</sup> 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.

<sup>43</sup> NCCF Report, *supra* note 2, at 106; *id.* at 113.

<sup>44</sup> 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.<sup>45</sup>

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."<sup>46</sup> Courts reasoned, "somewhat implausibly,"<sup>47</sup> that the "time price" was simply an offer to the buyer of a different price for the goods and not a loan.<sup>48</sup> 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.<sup>49</sup>

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.<sup>50</sup> 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.<sup>51</sup> In states with higher legal rate ceilings, by contrast, lenders were more

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<sup>45</sup> 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.

<sup>46</sup> See Durkin, Et al., *supra* note 25, at 487.

<sup>47</sup> *Id.*

<sup>48</sup> *Hogg v. Ruffner*, 66 U.S. 116 (1861).

<sup>49</sup> 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 can 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.*

<sup>50</sup> NCCF Report, *supra* note 2, at 123-28.

<sup>51</sup> 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.<sup>52</sup>

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.<sup>53</sup> 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.<sup>54</sup>

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.<sup>55</sup> 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.<sup>56</sup>

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.<sup>57</sup> Pawn shops often operated under distinct rules that permitted higher

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<sup>52</sup> See Smith, *supra* note 31, at 520.

<sup>53</sup> In addition to the costliness of operating a credit operation and the general risk of nonpayment, retailers were also reluctant to use 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.

<sup>54</sup> National Retail Merchants Association, *supra* note 40, at 51-52.

<sup>55</sup> 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).

<sup>56</sup> 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.

<sup>57</sup> 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,<sup>58</sup> overdraft protection,<sup>59</sup> or alternatives such as bounced checks and late bill payments.<sup>60</sup> 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.<sup>61</sup>

## 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.<sup>62</sup> 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.”<sup>63</sup>

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

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<sup>58</sup> See Neil Bhutta, Jacob Goldin, and Tatiana Homonoff, *Consumer Borrowing After Payday Loan Bans*, 59 J. L. & Econ. 225 (2016).

<sup>59</sup> 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).

<sup>60</sup> 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).

<sup>61</sup> See Gregory S. Elliehausen and Simona M. Hannon, *The Credit Card Act and Consumer Finance Company Lending*, 34 J. of Fin. Intermediation 109 (2018).

<sup>62</sup> See Durkin, *supra* note 25, at 500-501.

<sup>63</sup> 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.”<sup>64</sup> 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.”<sup>65</sup>

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.”<sup>66</sup> Greenspan described the plight of these borrowers in thrall to illegal lenders for “burdensome payments” as a condition of “virtual serfdom.”<sup>67</sup> It is estimated that, in 1911, 35 percent of New York City’s employees owed money to illegal lenders.<sup>68</sup> 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.<sup>69</sup>

Later in the 20th century, however, loan sharking operations became the province of organized crime, which enforced its racket by threats of physical violence.<sup>70</sup> For obvious reasons, the size of the illegal criminal loan shark racket has been difficult to measure.<sup>71</sup> 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.<sup>72</sup> For purposes of comparison, that estimated market size is about twice the size of the estimated \$32 billion payday loan market (storefront and online

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<sup>64</sup> NCCF Report, *supra* note 2, at 5.

<sup>65</sup> *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 loan shark incurred in transgressing the law.”)

<sup>66</sup> Greenspan, *supra* note 22.

<sup>67</sup> *Id.*; see also NCCF Report, *supra* note 2, at 46 (from 1880 to 1920 “urban America became the illegal lender’s paradise”).

<sup>68</sup> See Rowena Olegario, *The Engine of Enterprise: Credit in America* 108 (2016).

<sup>69</sup> Irving S. Michaelman, *Consumer Finance: A Case History in American Business* 110 (1966)

<sup>70</sup> 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 20<sup>th</sup> century.

<sup>71</sup> 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](https://www.realclearpolitics.com/articles/2019/06/02/the_sanders-aoc_protection_for_loan_sharks_act_140472.html).

<sup>72</sup> Ralph Salerno, *The Crime Confederation: Cosa Nostra and Allied Operations in Organized Crime* (1969).

combined) in the United States today.<sup>73</sup> 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.<sup>74</sup> 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.<sup>75</sup>

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.”<sup>76</sup> 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.<sup>77</sup> 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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<sup>73</sup> 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](https://s3.amazonaws.com/cfsi-innovation-files-2018/wp-content/uploads/2017/04/27001546/2017-Market-Size-Report_FINAL_4.pdf).

<sup>74</sup> 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).

<sup>75</sup> 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).

<sup>76</sup> Inquiry is Begun on Loan Sharks: Underworld’s Investment in Racket is Put at Billion, *New York Times* (Dec. 2, 1964).

<sup>77</sup> 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.<sup>78</sup>

### 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.”<sup>79</sup> 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.<sup>80</sup> 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.<sup>81</sup> 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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<sup>78</sup> Durkin, Et al., *supra* note 25, at 489.

<sup>79</sup> Durkin, Et al., *supra* note 25, at 489.

<sup>80</sup> 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).

<sup>81</sup> 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.”<sup>82</sup>

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.<sup>83</sup> 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.<sup>84</sup> Moreover, once legal, the market also became more transparent and competitive.<sup>85</sup> 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.<sup>86</sup> 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.<sup>87</sup> 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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<sup>82</sup> Anderson, *supra* note 80, *see also Current Legislation*, *supra* note 80, at 484.

<sup>83</sup> See George G. Bogert, *The Future of Small Loan Legislation*, 12 Univ. of Chicago L. Rev. 1 (1944).

<sup>84</sup> 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.”).

<sup>85</sup> 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.*

<sup>86</sup> Anderson, *supra* note 80, at 285.

<sup>87</sup> *Id.*

Rockefeller and Sage Foundations Send Envoy.”<sup>88</sup> Still, despite this “Bootleggers and Baptists”<sup>89</sup> 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.<sup>90</sup> 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.<sup>91</sup> In response to the Great Depression, which was seen at the time as having been precipitated in part by excessive use of consumer credit,<sup>92</sup> 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.<sup>93</sup> 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

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<sup>88</sup> 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.

<sup>89</sup> See Bruce Yandle, *Bootleggers and Baptists: The Education of a Regulatory Economist*, 7(3) *Regulation* 12 (May-June 1983).

<sup>90</sup> 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).

<sup>91</sup> See F.B. Hubachek, *The Development of Regulatory Small Loan Laws*, 8 *L. & Contemporary Problems* 108 (1941).

<sup>92</sup> 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 the Consumption Collapse of 1930*, 114 *Q. J. Econ.* 319 (1999); Barry Eichengreen and Kris Mitchener, *The Great Depression as a Credit Boom Gone Wrong*, *Bank for International Settlements BIS Working Papers No. 137* (Sept. 2003).

<sup>93</sup> NCCF Report, *supra* note 2, at 47.

as public utilities, such as hospitals).<sup>94</sup> 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.<sup>95</sup> 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.”<sup>96</sup> 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.”<sup>97</sup>

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 benefit 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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<sup>94</sup> 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”).

<sup>95</sup> See NCCF, *supra* note 2, at 114.

<sup>96</sup> NCCF, *supra* note 2, at 2.

<sup>97</sup> 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.<sup>98</sup>

## 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.*<sup>99</sup> 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.<sup>100</sup>

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.<sup>101</sup> 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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<sup>98</sup> NCCF, *supra* note 2, at 4.

<sup>99</sup> 439 U.S. 299 (1978).

<sup>100</sup> See Zywicki, *The Economics of Credit Cards*, *supra* note 32.

<sup>101</sup> 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.<sup>102</sup> 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.<sup>103</sup> 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.”<sup>104</sup> 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].”<sup>105</sup> 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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<sup>102</sup> 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.

<sup>103</sup> 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.”)

<sup>104</sup> 439 U.S. at 312 (quoting Stipulation of Facts, App. 91a).

<sup>105</sup> 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.<sup>106</sup> 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.<sup>107</sup> Consumers in Minnesota who were unable to gain adequate access to credit cards were forced to substitute to alternative types of credit.<sup>108</sup>

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.<sup>109</sup> 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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<sup>106</sup> See David S. Evans and Richard J. Schmalensee, *The Economics of the Payment Card Industry* 59 (1993).

<sup>107</sup> 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).

<sup>108</sup> 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.

<sup>109</sup> 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.<sup>110</sup> 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.<sup>111</sup> *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.<sup>112</sup> 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.<sup>113</sup>

**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<sup>114</sup>

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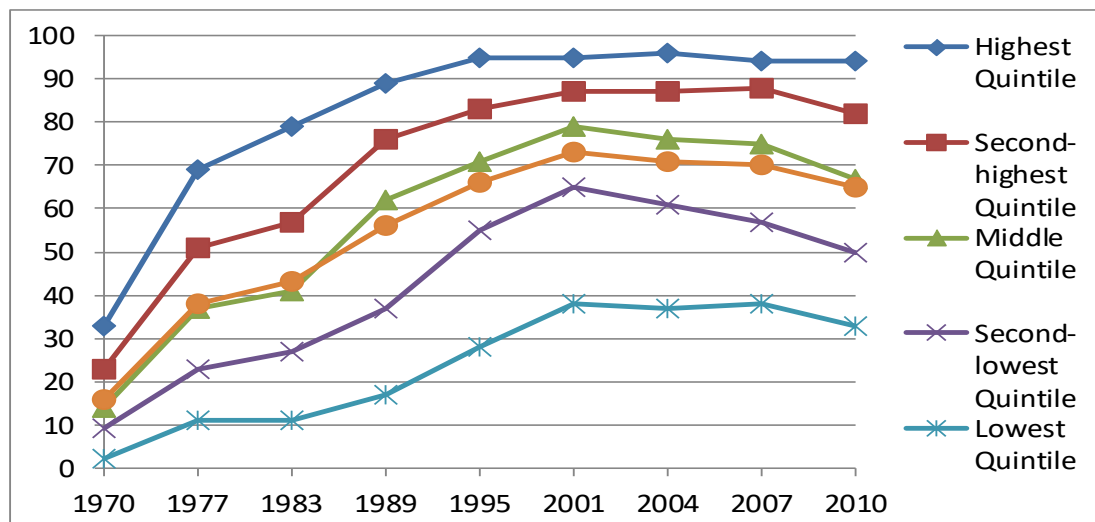
<sup>110</sup> The average American holds approximately three to four credit cards today. See Matt Tatham, *A Look at U.S. Consumer Credit Debt*, Experian.com (Nov. 4, 2019), available in <https://www.experian.com/blogs/ask-experian/state-of-credit-cards/>. The average number of credit cards held by 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>.

<sup>111</sup> See Christopher R. Knittel and Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards*, 93 Am. Econ. Rev. 1703 (2003).

<sup>112</sup> “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.

<sup>113</sup> 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.

<sup>114</sup> 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.<sup>115</sup> 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.<sup>116</sup> 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.

<sup>115</sup> See discussion in Chapter 2; see also Durkin, Et al., *supra* note 25, at 39-41.

<sup>116</sup> See Zywicki, *Economics of Credit Cards*, *supra* note 32.

cardholders in 1989.”<sup>117</sup> There also was an increased share of younger households. The median 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.<sup>118</sup> 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.<sup>119</sup>

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.<sup>120</sup> 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.<sup>121</sup> 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.<sup>122</sup>

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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<sup>117</sup> 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).

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* at 3.

<sup>120</sup> 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](https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202016/Unbanked_October2016.pdf).

<sup>121</sup> See Durkin, Et al., *supra* note 25, at 216-229.

<sup>122</sup> 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.”<sup>123</sup> 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.<sup>124</sup> 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”).<sup>125</sup> 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.<sup>126</sup> As discussed in Chapter 9 as well as below, creditors and CRAs have continued to innovate in their credit

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<sup>123</sup> See Durkin, Et al., *supra* note 25, at 216-217.

<sup>124</sup> *Id.* at 217.

<sup>125</sup> *Id.* at 220.

<sup>126</sup> *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.<sup>127</sup> 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.<sup>128</sup>

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<sup>127</sup> Durkin, Et al., *supra* note 25, at 268-69.

<sup>128</sup> 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.<sup>129</sup> 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.<sup>130</sup> In addition, the Federal Reserve 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.<sup>131</sup> Unbanked rates are higher than average for lower-income and less-educated households,

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<sup>129</sup> 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).

<sup>130</sup> 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).

<sup>131</sup> *Id.*



minority households (Black or African American, Hispanic, and American Indian or Alaska Native), working-age disabled households, and households with more volatile income.<sup>132</sup>

A central element of the FDIC survey is to ask unbanked consumers why they do not have a bank account.<sup>133</sup> 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.<sup>134</sup> Respondents to the 2017 Survey provided a similar ranking of reasons for not having a bank account.<sup>135</sup>

Although the pattern of these answers has been generally consistent over the last several surveys, this has not always been the case.<sup>136</sup> The 2011 and 2009 surveys asked different questions, and unbanked consumers answered them in different ways, so they are difficult to

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<sup>132</sup> 2019 FDIC Survey, *supra* note 129, at 1.

<sup>133</sup> 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)

<sup>134</sup> 2019 FDIC Survey, *supra* note 129.

<sup>135</sup> 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)

<sup>136</sup> 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.<sup>137</sup> 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.<sup>138</sup> 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).<sup>139</sup> 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.<sup>140</sup> Unbanked consumers might also distrust banks because they feel like banks present many traps for the unwary—bank

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<sup>137</sup> 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).

<sup>138</sup> 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.

<sup>139</sup> See 2009 FDIC Survey, *supra* note 137, at 25, Fig. 4.12.

<sup>140</sup> 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.<sup>141</sup>

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.<sup>142</sup> 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.<sup>143</sup> Banks inexplicably can still take three days or longer to grant customers access to their deposits.<sup>144</sup> 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.<sup>145</sup> 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.<sup>146</sup> 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.<sup>147</sup> 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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<sup>141</sup> 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.*

<sup>142</sup> See 2019 FDIC Survey, *supra* note 129, at 35.

<sup>143</sup> 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.

<sup>144</sup> See George Selgin and Aaron Klein, *We Shouldn't Have to Wait for FedNow to Have Faster Payments*, *Am. Banker* (Feb. 28, 2020).

<sup>145</sup> *Id.*

<sup>146</sup> 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>.

<sup>147</sup> See Aaron Klein, *The Fastest Way to Address Income Inequality? Implement a Real time Payment System*, [www.Brookings.edu](https://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](https://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.<sup>148</sup> 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.<sup>149</sup>

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.<sup>150</sup> 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.<sup>151</sup> 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.<sup>152</sup> 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.<sup>153</sup> Anti-money laundering laws have also been identified as a potential

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<sup>148</sup> 2019 FDIC Survey, *supra* note 129.

<sup>149</sup> 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](http://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.

<sup>150</sup> See David Benoit, *Ex-Inmates Struggle in Banking System*, Wall St. J. at p. B9 (Nov. 2, 2020).

<sup>151</sup> 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).

<sup>152</sup> See Benoit, *supra* note 150.

<sup>153</sup> 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,<sup>154</sup> despite how greater use of FinTech to facilitate cross-border transactions could simultaneously increase both financial inclusion and anti-money laundering compliance.<sup>155</sup> 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.”<sup>156</sup> 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.<sup>157</sup>

There are two groups of consumers that are not fully “visible” to the consumer finance system.<sup>158</sup> 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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<sup>154</sup> See David R. Burton and Norbert J. Michel, *Financial Privacy in a Free Society*, Heritage Foundation Backgrounder 14-15 (Sept. 23, 2016).

<sup>155</sup> 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).

<sup>156</sup> Asli Demirgüç-Kunt and Leora Klapper, *Measuring Financial Inclusion: The Global Findex Database 20*, World Bank Policy Research Working Paper 6025 (Apr. 2012).

<sup>157</sup> See Consumer Financial Protection Bureau, *Data Point: Credit Invisibles* (May 2015).

<sup>158</sup> *Id.* at 4.

consumers as “unscorable,” meaning “they contain insufficient credit histories to generate a credit score.”<sup>159</sup>

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.<sup>160</sup> 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.”<sup>161</sup> 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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<sup>159</sup> 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.

<sup>160</sup> *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).

<sup>161</sup> 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.<sup>162</sup> 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.<sup>163</sup> The HOLC was established in 1933 to deal with the problem of rising home foreclosures during the Great Depression.<sup>164</sup> 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."<sup>165</sup> 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.<sup>166</sup>

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.<sup>167</sup> One statistical analysis of mortgage lending patterns during the New Deal in Philadelphia concluded that private lenders continued

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<sup>162</sup> 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).

<sup>163</sup> 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.

<sup>164</sup> See Nier, *supra* note 162, at 175.

<sup>165</sup> Nier, *supra* note 162, at 177.

<sup>166</sup> "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.

<sup>167</sup> 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."<sup>168</sup> 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.<sup>169</sup>

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.<sup>170</sup> "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."<sup>171</sup> 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.<sup>172</sup> Redlined areas also experienced large differential declines in population during that period.<sup>173</sup> 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.<sup>174</sup> Krimmel found similar adverse effects stemming from redlining for redlined neighborhoods that were homogeneously White at the beginning of the period.<sup>175</sup> 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.<sup>176</sup> Krimmel notes that although Blacks comprised only 8 percent of the sample

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<sup>168</sup> 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.*

<sup>169</sup> *Id.*

<sup>170</sup> 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).

<sup>171</sup> Hillier, *supra* note 170, at 19.

<sup>172</sup> See Jacob Krimmel, Persistence of Prejudice: Estimating the Long Term Effects of Redlining, Working Paper (Nov. 2020).

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> 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.<sup>177</sup>

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.<sup>178</sup> 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.<sup>179</sup> 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.<sup>180</sup> 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.<sup>181</sup> 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."<sup>182</sup> 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.<sup>183</sup> 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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<sup>177</sup> *Id.* at 13, Table 2.

<sup>178</sup> See Nier, *supra* note 162, at 180-81.

<sup>179</sup> 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).

<sup>180</sup> Nier, *supra* note 162, at 183

<sup>181</sup> Rothstein, *supra* note 179.

<sup>182</sup> 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)).

<sup>183</sup> 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.”<sup>184</sup>

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.<sup>185</sup> For many middle-class and working-class families, home ownership represents a significant portion of their household wealth.<sup>186</sup> Subsequently, the United States Supreme Court invalidated racially-exclusionary covenants in housing<sup>187</sup> and Congress adopted the Fair Housing Act in 1968 that formally did away with the federal government’s discriminatory lending mandates.<sup>188</sup> 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.<sup>189</sup> For many middle-class and working-class families, home ownership represents a significant portion of their household wealth.<sup>190</sup> 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,

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<sup>184</sup> 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>.

<sup>185</sup> 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).

<sup>186</sup> 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.

<sup>187</sup> *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).

<sup>188</sup> 42. U.S.C. § 3601, *et seq.*

<sup>189</sup> 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).

<sup>190</sup> 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<sup>191</sup>

## 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.”<sup>192</sup> 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.<sup>193</sup> 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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<sup>191</sup> 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, Stuart 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>.

<sup>192</sup> Louis Hyman, *Debtor Nation: The History of America in Red Ink* 173-74 (2011).

<sup>193</sup> 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.<sup>194</sup> 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

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<sup>194</sup> 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.<sup>195</sup> 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.<sup>196</sup> 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.<sup>197</sup> 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.<sup>198</sup>

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.”<sup>199</sup>

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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<sup>195</sup> 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.

<sup>196</sup> Day and Brandt, *supra* note 195, at 83.

<sup>197</sup> Day and Brandt, *supra* note 195, at 102. Day and Brandt do not determine the accuracy of that perception.

<sup>198</sup> *Id.*

<sup>199</sup> Hyman, *supra* note 192, at 175.

income households were made on credit.<sup>200</sup> 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.<sup>201</sup> 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.”<sup>202</sup> 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.<sup>203</sup> Moreover many “downtown” department stores shunned Black patrons whereas local stores, typically Black-owned and operated, welcomed them.<sup>204</sup> 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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<sup>200</sup> David Caplovitz, *The Poor Pay More* 16-20 (1967). Caplovitz’s study was originally published in 1963.

<sup>201</sup> 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.

<sup>202</sup> Hyman, *supra* note 192, at 176.

<sup>203</sup> Hyman, *supra* note 192, at 176 (“Credit tied lower-income consumers to neighborhood merchants, who enabled them to buy more, but at higher prices.”).

<sup>204</sup> 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.”<sup>205</sup>

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.<sup>206</sup> 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.<sup>207</sup> 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.<sup>208</sup> Thus, the same research found that almost all buyers knew the maturity, amount financed, and monthly payment associated with their credit.<sup>209</sup>

Despite charging high prices, merchants in lower-income neighborhoods actually earned lower returns on investment than mainstream competitors.<sup>210</sup> 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.<sup>211</sup> 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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<sup>205</sup> Hyman, *supra* note 192, at 176.

<sup>206</sup> 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).

<sup>207</sup> 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.*

<sup>208</sup> 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.

<sup>209</sup> *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.

<sup>210</sup> See NCCF Report *supra* note 2, at 181 (citing Federal Trade Commission, *supra* note 201).).

<sup>211</sup> Hyman, *supra* note 192, at 178.



an installment basis with the goods serving as collateral that lenders could repossess upon default.<sup>212</sup> 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.<sup>213</sup> 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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<sup>212</sup> 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).

<sup>213</sup> 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.<sup>214</sup> Eliminating restrictions on branch banking that prevented entry by successful banks that might want to expand operations into lower-income communities was also urged.<sup>215</sup>

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.<sup>216</sup> 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.<sup>217</sup> Although the idea of a Black-owned bank was first discussed prior to the Civil War,<sup>218</sup> 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.<sup>219</sup> 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.”<sup>220</sup> 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-

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<sup>214</sup> 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.

<sup>215</sup> Hyman, *supra* note 192, at 185.

<sup>216</sup> 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/>.

<sup>217</sup> See Tim Todd, *Let Us Put Our Money Together: The Founding of America’s First Black Banks 1-19* (2019).

<sup>218</sup> *Id.*

<sup>219</sup> 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).

<sup>220</sup> 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.”<sup>221</sup>

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.<sup>222</sup> 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.<sup>223</sup> 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.<sup>224</sup>

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.<sup>225</sup> 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.”<sup>226</sup> 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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<sup>221</sup> *Id.*

<sup>222</sup> Hyman, *supra* note 192, at 184-85; *see also* Ammons, *supra* note 219-219.

<sup>223</sup> Ammons, *supra* note 219, at 474-75.

<sup>224</sup> *See* Burton, Scheck, and West, *supra* note 219-219.

<sup>225</sup> Hyman, *supra* note 192, at 188.

<sup>226</sup> *Id.* at 189

black or white.”<sup>227</sup> 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.<sup>228</sup> 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.<sup>229</sup> 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.<sup>230</sup>

Minority households also have lower net wealth on average than White households.<sup>231</sup> 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.<sup>232</sup> 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.<sup>233</sup> 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.<sup>234</sup> 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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<sup>227</sup> *Id.*

<sup>228</sup> *Id.* at 190

<sup>229</sup> Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 27-28.

<sup>230</sup> 2019 FDIC Survey, *supra* note 129, at 1.

<sup>231</sup> 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).

<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

<sup>234</sup> *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.<sup>235</sup> Blacks and Hispanic households are less likely than White households to have a credit card.<sup>236</sup>

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.<sup>237</sup> 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.<sup>238</sup>

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.<sup>239</sup> 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.<sup>240</sup> 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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<sup>235</sup> See Bhutta, et al., *Disparities in Wealth*, *supra* note 231.

<sup>236</sup> Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 27-28.

<sup>237</sup> 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>.

<sup>238</sup> 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).

<sup>239</sup> 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).

<sup>240</sup> Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 51.

substantive differences in risk tolerance.<sup>241</sup> 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.<sup>242</sup>

## 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<sup>243</sup> 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.<sup>244</sup> As Hyman observes, “The existence or lack of individual credit histories

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<sup>241</sup> Hanna, et al., *supra* note 239, at 46.

<sup>242</sup> 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.

<sup>243</sup> Hyman, *supra* note 192, at 193.

<sup>244</sup> NCCF Report, *supra* note 2, at 152-53.

for women drove many of the differences in credit access between single, married, and divorced women.”<sup>245</sup>

As early as the 1920s, department stores “had readily provided charge cards to single women who had sufficient income to qualify.”<sup>246</sup> Although women faced disparagement from moralists and merchants for their borrowing, they outnumbered men in stores, pawnshops, and lending offices.<sup>247</sup> 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.<sup>248</sup>

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.”<sup>249</sup> 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.”<sup>250</sup> 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.<sup>251</sup> 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.<sup>252</sup>

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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<sup>245</sup> Hyman, *supra* note 192, at 193.

<sup>246</sup> *Id.*

<sup>247</sup> See, e.g. Chapter 8, Appendix B (citing sources).

<sup>248</sup> *Id.*

<sup>249</sup> *Id.*

<sup>250</sup> *Id.* at 203.

<sup>251</sup> *Id.*

<sup>252</sup> *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.<sup>253</sup> 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.<sup>254</sup> 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.<sup>255</sup> 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 than 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.<sup>256</sup>

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.<sup>257</sup> 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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<sup>253</sup> *Id.* at 198.

<sup>254</sup> *Id.* at 201.

<sup>255</sup> 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/>.

<sup>256</sup> *Id.*; see also Bijou Yang and David Lester, *Correlates of Credit Card Ownership in Men and Women*, 96 *Psychological Reports* 912 (2005).

<sup>257</sup> 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.<sup>258</sup> 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.<sup>259</sup> 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<sup>260</sup> and express lower levels of confidence in their ability to make investment decisions,<sup>261</sup> leading them to prefer less-risky but less-rewarding investment strategies over time.<sup>262</sup> 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.<sup>263</sup> 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.<sup>264</sup> 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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<sup>258</sup> *Id.*

<sup>259</sup> *Id.* Women with children, of course, are also more likely to experience career interruption and competing pressures from family obligations than men.

<sup>260</sup> *Id.*

<sup>261</sup> Federal Reserve Board, Report on Economic Well-Being 2020, *supra* note 130, at 52.

<sup>262</sup> 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.

<sup>263</sup> 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).

<sup>264</sup> 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.”<sup>265</sup> 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.<sup>266</sup> 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.<sup>267</sup>

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.<sup>268</sup>

Empirical evidence of the overall effect of ECOA on addressing discrimination in consumer lending markets has been mixed.<sup>269</sup> While ECOA has had economic and social benefits, it has also had costs.<sup>270</sup> 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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<sup>265</sup> *Id.* at 212.

<sup>266</sup> Report to Congress, *supra* note 126, at 44.

<sup>267</sup> 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 Affairs, No. 2010-58 (Oct. 12, 2010).

<sup>268</sup> See discussion at *supra* note 254 and accompanying text.

<sup>269</sup> 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.

<sup>270</sup> 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.<sup>271</sup> In addition, several studies found that ECOA and Regulation B increased costs for financial institutions.<sup>272</sup> 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.<sup>273</sup>

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.<sup>274</sup> The Taskforce believes Congress and regulators should examine ECOA and consider updating it to cover new situations and classes of covered persons while also

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<sup>271</sup> Durkin, Et al., *supra* note 25, at 447 (summarizing studies)

<sup>272</sup> See Durkin, Et al., *supra* note 25, at 448, n. 41 (summarizing studies).

<sup>273</sup> 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)).

<sup>274</sup> 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.<sup>275</sup> 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

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<sup>275</sup> 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.<sup>276</sup>

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.<sup>277</sup>

Economists have argued that where discrimination exists, it tends to be more prevalent and persistent in monopolistic industries than in competitive industries.<sup>278</sup> This tendency may be particularly strong in markets characterized by government-created regulatory barriers to entry and competition.<sup>279</sup> 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.<sup>280</sup> The federal government's ability to maintain racial segregation in housing finance markets for decades is illustrative. Long-term

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<sup>276</sup> See discussion at *supra* notes 195-198 and accompanying text.

<sup>277</sup> 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).

<sup>278</sup> See Gary Becker, *The Economics of Discrimination* (2d ed., 1971).

<sup>279</sup> 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>.

<sup>280</sup> 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.<sup>281</sup> 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.<sup>282</sup> Other studies have found increased competition in consumer credit markets reduces disparities in access to and the terms of consumer financial products.<sup>283</sup> 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.<sup>284</sup>

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.<sup>285</sup> 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.<sup>286</sup> Brevoort also found no evidence of systematic racial differences in credit card access.<sup>287</sup> 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.<sup>288</sup>

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<sup>281</sup> 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).

<sup>282</sup> See Celerier & Matray, *supra* note 120.

<sup>283</sup> 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).

<sup>284</sup> 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](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).

<sup>285</sup> See Alexander W. Butler, Erik J. Mayer, and James P. Weston, *Racial Discrimination in the Auto Loan Market* at 19, [www.SSRN.com](http://www.SSRN.com) (June 2020), available in [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3301009](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3301009).

<sup>286</sup> *Id.*

<sup>287</sup> See Kenneth P. Brevoort, *Credit Card Redlining Revisited*, 93 *Rev. Econ. and Stats.* 714 (2011).

<sup>288</sup> 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.<sup>289</sup>

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.<sup>290</sup> 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](https://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](http://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.*

<sup>289</sup> See NCCF Report, *supra* note 2, at 158-60.

<sup>290</sup> 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.<sup>291</sup> 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 Currency (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

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<sup>291</sup> 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.<sup>292</sup> 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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<sup>292</sup> 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.<sup>293</sup> 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.<sup>294</sup>

Payment card systems are a prominent example of what has come to be known as a “two-sided market.”<sup>295</sup> 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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<sup>293</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624002).

<sup>294</sup> For a more detailed explanation of the operation of payment card systems, see Zywicki, *supra* note 293, at 27-30.

<sup>295</sup> 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.<sup>296</sup>

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.<sup>297</sup> 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.<sup>298</sup>

More fundamental, the costs of operating the platform must come from merchants and consumers.<sup>299</sup> 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.<sup>300</sup> 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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<sup>296</sup> *Ohio v. American Express Co.*, 585 U.S. \_\_\_, slip op. at 2 (2018).

<sup>297</sup> See William F. Baxter, Bank Interchange of Transactional Paper: Legal and Economic Perspectives, 26 J. L. & Econ. 541 (1983).

<sup>298</sup> See Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1 (1960).

<sup>299</sup> See Zywicki, *supra* note 293, at 31-32.

<sup>300</sup> 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.<sup>301</sup>

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.<sup>302</sup> 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.<sup>303</sup> 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.<sup>304</sup> 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.<sup>305</sup> By 2006, however, debit cards passed credit cards to become the second most-popular noncash

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<sup>301</sup> See Zywicki, *supra* note 293, at 33.

<sup>302</sup> 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.

<sup>303</sup> 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.>

<sup>304</sup> 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](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.

<sup>305</sup> 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.<sup>306</sup> 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.<sup>307</sup> By 2009, 76 percent of bank accounts were free checking accounts, according to one widely-cited estimate.<sup>308</sup> 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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<sup>306</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080).

<sup>307</sup> 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).

<sup>308</sup> 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 as 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.<sup>309</sup>

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.<sup>310</sup> The direct effect on covered banks was initially estimated as a reduction in annual revenue of approximately \$4.1-\$6.5 billion<sup>311</sup> 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.<sup>312</sup>

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

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<sup>309</sup> Board of Governors for 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>

<sup>310</sup> 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 for 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>.

<sup>311</sup> See Benjamin S. Kay, Mark D. Manuszak, and Cindy M. Vojtech, *Competition and Complementarities in Retail Banking: Evidence from 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](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2285105) (estimating annual revenue loss of \$6.6 billion to \$8 billion from Durbin Amendment).

<sup>312</sup> 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.<sup>313</sup>

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.<sup>314</sup> By 2013, that figure had fallen in half, to 38 percent.<sup>315</sup> At the same time, monthly maintenance fees for non-free checking accounts rose substantially, doubling in amount according to some estimates.<sup>316</sup> 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.<sup>317</sup> The percentage of bank accounts subject to free checking has remained near this level since.<sup>318</sup>

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.<sup>319</sup> 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).<sup>320</sup>

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.<sup>321</sup> Mukharlyamov and Sarin estimated that issuers lost approximately \$5.5 billion in reduced interchange fee income

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<sup>313</sup> Zywicki, *Economics of Credit Cards*, *supra* note 32, at 158-59.

<sup>314</sup> See Zywicki, et al., *Price Controls*, *supra* note 306, at 6.

<sup>315</sup> Zywicki, et al., *Price Controls*, *supra* note 306, at 6.

<sup>316</sup> Zywicki, et al., *Price Controls*, *supra* note 306, at 7.

<sup>317</sup> Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 310, at 12.

<sup>318</sup> Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 310, at 11.

<sup>319</sup> Mukharlyamov and Sarin, *supra* note 311, at 4.

<sup>320</sup> 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).

<sup>321</sup> 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.<sup>322</sup>

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.<sup>323</sup> 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.<sup>324</sup> 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 qualify for noninterest free checking accounts increased by over \$400 and by nearly \$1,700 for interest-bearing checking accounts.<sup>325</sup>

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."<sup>326</sup> 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

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<sup>322</sup> 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.

<sup>323</sup> Zywicki, et al., *Unreasonable and Disproportionate*, *supra* note 310, at 11.

<sup>324</sup> Mukharlyamov and Sarin estimated a 21 percent increase in the monthly minimum needed to be eligible for free checking and to avoid having to pay monthly fees.

<sup>325</sup> 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.

<sup>326</sup> 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.”<sup>327</sup>

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.<sup>328</sup> 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.<sup>329</sup> 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.<sup>330</sup> 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.<sup>331</sup> 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.<sup>332</sup> 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.<sup>333</sup> 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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<sup>327</sup> *Id.* at 30.

<sup>328</sup> See Zywicki, et al., *Price Controls, Price Controls*, *supra* note 306.

<sup>329</sup> See discussion at *supra* note 137 and accompanying text.

<sup>330</sup> Mukharlyamov and Sarin, *supra* note 311, at 30.

<sup>331</sup> *Id.*

<sup>332</sup> 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.

<sup>333</sup> Kay, et al., *supra* note 311, at 99.

credit cards for transactional purposes in place of debit cards.<sup>334</sup> 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.<sup>335</sup> 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.”<sup>336</sup> 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.<sup>337</sup>

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.<sup>338</sup> 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.<sup>339</sup>

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<sup>334</sup> 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 Preferences 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).

<sup>335</sup> 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.

<sup>336</sup> Ankana, *supra* note 334, at 11.

<sup>337</sup> 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).

<sup>338</sup> 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>.

<sup>339</sup> 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.<sup>340</sup> 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.<sup>341</sup> 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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<sup>340</sup> 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).

<sup>341</sup> Zhu Wang, Scarlett Schwartz, and Neil Mitchell, *The Impact of the Durbin Amendment on Merchants: A Survey Study*, 100(3) *Econ. Q.* 183 (2014) (3<sup>rd</sup> 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<sup>342</sup> 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.<sup>343</sup> 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.<sup>344</sup>

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.<sup>345</sup>

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.

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<sup>342</sup> 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.

<sup>343</sup> Pub. L. No. 111-24, 23 Stat. 1734 (2009).

<sup>344</sup> 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.

<sup>345</sup> 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."<sup>346</sup> 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.<sup>347</sup> 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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<sup>346</sup> Statement of Governor Randall S. Kroszner (Dec. 18, 2008), *available in* <https://www.federalreserve.gov/newsevents/pressreleases/kroszner20081218a.htm>.

<sup>347</sup> 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.<sup>348</sup> They found that the 2008 regulations and the CARD Act had similar and separate effects on consumers.<sup>349</sup> 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.<sup>350</sup>

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

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<sup>348</sup> 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).

<sup>349</sup> 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.

<sup>350</sup> 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.<sup>351</sup> 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.<sup>352</sup> 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."<sup>353</sup> 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.<sup>354</sup>

Lux and Greene found a variety of developments in the credit card market that are likely attributable to the impact of the CARD Act.<sup>355</sup> 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.<sup>356</sup> 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.<sup>357</sup> 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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<sup>351</sup> 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.

<sup>352</sup> 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).

<sup>353</sup> *Id.* at 4.

<sup>354</sup> *Id.* at 4.

<sup>355</sup> 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).

<sup>356</sup> Goldman Sachs, *Who Pays for Bank Regulation?* 7 (June 2014).

<sup>357</sup> 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.”<sup>358</sup>

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.”<sup>359</sup>

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.<sup>360</sup> 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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<sup>358</sup> Elliehausen and Hannon, *supra* note 61.

<sup>359</sup> Elliehausen and Hannon, *supra* note 61.

<sup>360</sup> Consumer Financial Protection Bureau, CARD Act Report: A Review of the Impact of the CARD Act on the Consumer Credit Market (Oct 2013),



sharply.”<sup>361</sup> 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.<sup>362</sup> 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.<sup>363</sup> 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.

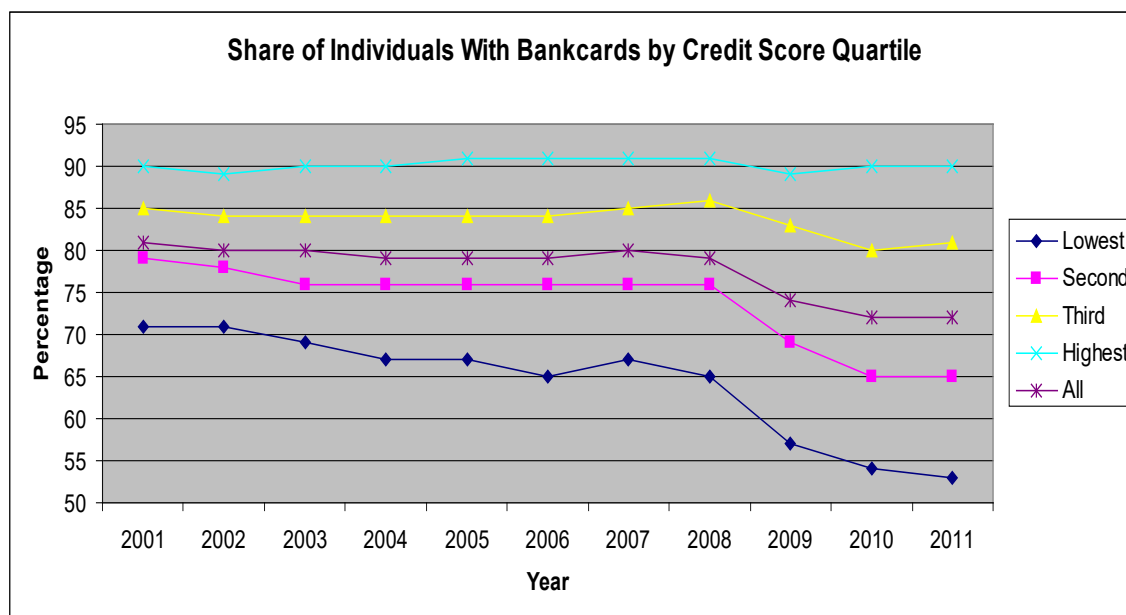
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<sup>361</sup> Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki, *An Assessment of Behavioral Law and Economics Contentions and What We Know Empirically about Credit Card Use by Consumers*, 22 S. Ct. Econ. Rev. 1, 48 (2014).

<sup>362</sup> 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).

<sup>363</sup> 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.”<sup>364</sup> 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

<sup>364</sup> 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.<sup>365</sup>

Three studies have purported to find minimal adverse effects on consumers from enactment of the CARD Act.<sup>366</sup> 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.<sup>367</sup> 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.<sup>368</sup>

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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<sup>365</sup> See discussion at *supra* note 361 and accompanying text.

<sup>366</sup> 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).

<sup>367</sup> 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.

<sup>368</sup> 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 366 (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.”<sup>368</sup> 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.<sup>369</sup> 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.<sup>370</sup> 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.<sup>371</sup> 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

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<sup>369</sup> 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)

<sup>370</sup> See United States Postal Service, Office of Inspector General, *The Road Ahead for Postal Financial Services* (May 21, 2015); see also Mehrsa Baradaran, *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).

<sup>371</sup> 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.<sup>372</sup> 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.<sup>373</sup>

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.<sup>374</sup> 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.<sup>375</sup>

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<sup>372</sup> 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/>.

<sup>373</sup> 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/>.

<sup>374</sup> See 2019 FDIC Survey, *supra* note 129, at 17 Fig. 3.5.

<sup>375</sup> 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-stated 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.<sup>376</sup> 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,”<sup>377</sup> 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.<sup>378</sup> Increased competition and innovation in the market for money transfers and remittances has driven down the price of those products elsewhere.<sup>379</sup> Retailers such as Walmart also currently offer longer hours that are more convenient for financial activities than the Postal Service.<sup>380</sup> 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](https://www.Alt-M.org), available in <https://www.alt-m.org/2020/10/16/going-postal-proposals-for-post-office-banking-in-2020/>.

<sup>376</sup> See Todd Zywicki, *Postal Banking Isn't the Fix for Financial Inclusion*, *American Banker* (June 13, 2019).

<sup>377</sup> 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.

<sup>378</sup> 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).

<sup>379</sup> See Mauro F. Romaldini, *How Is the International Money Transfer Market Evolving?*, [www.Toptal.com](https://www.toptal.com/finance/market-research-analysts/international-money-transfer) (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.

<sup>380</sup> 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 20<sup>th</sup> 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.<sup>381</sup>

### 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.<sup>382</sup> 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<sup>383</sup> and to propose a new rule for chartering industrial banks and industrial loan companies.<sup>384</sup> 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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<sup>381</sup> See Testimony of Merhssa 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).

<sup>382</sup> See Zywicki, *Postal Banking*, *supra* note 376.

<sup>383</sup> 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/>.

<sup>384</sup> 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.<sup>385</sup>

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.<sup>386</sup> 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.<sup>387</sup> 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.”<sup>388</sup> 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

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<sup>385</sup> See Selgin and Klein, *supra* note 144.

<sup>386</sup> See Bureau of Consumer Financial Protection, Advisory Opinion: Truth in Lending (Regulation Z); Earned Wage Access programs (Nov. 30, 2020).

<sup>387</sup> *Id.* at 2.

<sup>388</sup> *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.<sup>389</sup> 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).

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<sup>389</sup> 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](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.<sup>390</sup> 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.<sup>391</sup>

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.<sup>392</sup> 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

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<sup>390</sup> See Ronald Coase, *the Nature of The Firm*, 4 *Economica* 386 (1937); see also Charles Calomiris and Thanavut Pornrojngangkool, *Relationship Banking and the Pricing of Financial Services*, 35 *J. of Fin. Servs. Research* 189 (2009).

<sup>391</sup> See Charles W. Calomiris, *Gauging the Efficiency of Bank Consolidation During a Merger Wave*, 23 *J. of Banking and Fin.* 615 (1999).

<sup>392</sup> 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.<sup>393</sup> 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.<sup>394</sup> 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.<sup>395</sup> 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.<sup>396</sup> Prepaid cards are almost four times more likely to be used by unbanked consumers

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<sup>393</sup> *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).

<sup>394</sup> 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.

<sup>395</sup> See Testimony of Merhssa Baradaran before the United States House of Representatives Committee on Financial Services Task Force on Financial Technology (June 11, 2020).

<sup>396</sup> General-purpose prepaid debit cards now account for 10.5 percent of all card payments in the United States. 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.<sup>397</sup> 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.<sup>398</sup> 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.<sup>399</sup>

FinTech providers have been active in developing products that can provide low-cost or free transaction accounts to consumers.<sup>400</sup> 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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<sup>397</sup> 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.

<sup>398</sup> 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).

<sup>399</sup> 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/>.

<sup>400</sup> 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.cnn.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.<sup>401</sup>

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.<sup>402</sup> 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.<sup>403</sup> Other technology companies are developing technological solutions that have enabled consumers to move in and out of existing payment and banking relationships.<sup>404</sup>

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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<sup>401</sup> 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/>.

<sup>402</sup> *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).

<sup>403</sup> *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>.

<sup>404</sup> *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.”<sup>405</sup> 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.<sup>406</sup> 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.<sup>407</sup> 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.<sup>408</sup>

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.<sup>409</sup> 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

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<sup>405</sup> See Aaron Klein, China’s Digital Payments Revolution (Apr. 2020), available in <https://www.brookings.edu/research/chinas-digital-payments-revolution/>.

<sup>406</sup> *Id.*

<sup>407</sup> See *id.* at 15-16; see also Lucas Jankowiak, *Payments Innovation Is “Unbundling” Banking*, [www.PaymentsSource.com](http://www.PaymentsSource.com) (Apr. 17, 2017), available in <https://www.paymentsource.com/opinion/payments-innovation-is-unbundling-banking>.

<sup>408</sup> See Craig Torres, *Bankers Advising Fed Board Describe Libra as a Monetary Threat*, [www.Bloomberg.com](http://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>.

<sup>409</sup> 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.”<sup>410</sup> According to a 2017 CFPB Report, 37.6 percent of newly credit visible consumers used a credit

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<sup>410</sup> 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.<sup>411</sup> 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.<sup>412</sup> 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.<sup>413</sup>

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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<sup>411</sup> 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).

<sup>412</sup> 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.

<sup>413</sup> See Durkin, Et al., *supra* note 25, at 358.



card.<sup>414</sup> 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.<sup>415</sup> 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.<sup>416</sup> 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.<sup>417</sup> 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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<sup>414</sup> *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.*

<sup>415</sup> 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](http://www.Wallethub.com) (Dec. 21, 2020), available in [wallethub.com/credit-cards/bad-credit-unsecured/](http://wallethub.com/credit-cards/bad-credit-unsecured/).

<sup>416</sup> 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].”).

<sup>417</sup> 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.<sup>418</sup> Rejection rates on applications are high, imposing costs on the issuer in terms of verification and processing.<sup>419</sup> Loss rates from defaults and delinquencies are exceedingly high, as would be predicted in dealing with a group of high-risk consumers.<sup>420</sup> 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.<sup>421</sup> 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.<sup>422</sup>

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.<sup>423</sup> 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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<sup>418</sup> See Durkin, Et al., *supra* note 25, at 358.

<sup>419</sup> 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)).

<sup>420</sup> 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.

<sup>421</sup> 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)).

<sup>422</sup> See Durkin, Et al., *supra* note 25, at 358.

<sup>423</sup> 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.<sup>424</sup> 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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<sup>424</sup> 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.<sup>425</sup> 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.<sup>426</sup> 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.<sup>427</sup> 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.<sup>428</sup>

In one study, economists Julapa Jagtiani and Catharine Lemieux examined the use of alternative data to make loan decisions by the FinTech company LendingClub.<sup>429</sup> 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.”<sup>430</sup> 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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<sup>425</sup> Durkin, Et al., *supra* note 25, at 228.

<sup>426</sup> See Michael A. Turner, Patrick D. Walkder, Sukanya Chaudhuri, and Robin Varghese, *A New Pathway to Financial Inclusion: Alternative Data, Credit Building and Responsible Lending in the Wake of the Great Recession* (2012).

<sup>427</sup> 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](https://finreglab.org/wp-content/uploads/2019/07/FRL_Research-Report_Final.pdf).

<sup>428</sup> FinRegLab, *Data Diversification in Credit Underwriting: Research Brief* (Oct. 2020).

<sup>429</sup> See Julapa Jagtiani and Catharine Lemieux, *The Roles of Alternative Data and Machine Learning in FinTech Lending: Evidence from 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

<sup>430</sup> *Id.* at 12.

supply, such as those with highly concentrated markets and areas with fewer bank branches per capita.<sup>431</sup>

Use of traditional credit scoring for loan underwriting and pricing also appears to have a disparate impact on immigrants.<sup>432</sup> This appears to be because recent immigrants, regardless of age, lack sufficiently seasoned credit records<sup>433</sup> and as a result “resemble those of younger individuals, whose credit performance tends to be poor relative to the rest of the population.”<sup>434</sup> 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.<sup>435</sup> 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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<sup>431</sup> 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).

<sup>432</sup> See Federal Reserve Board, Report to Congress, *supra* note 126, at 47.

<sup>433</sup> *Id.* at p. S-5.

<sup>434</sup> *Id.* at p. S-2.

<sup>435</sup> *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.”<sup>1</sup> 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.*”<sup>2</sup> 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.

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<sup>1</sup> Report of The National Commission on Consumer Finance, Consumer Credit in the United States 212 (Dec. 1972).

<sup>2</sup> 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.”<sup>3</sup> 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

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<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup>

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.<sup>7</sup>

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.

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<sup>4</sup> 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).

<sup>5</sup> 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).

<sup>6</sup> See Chapter 7, text accompanying notes 15-23.

<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup>

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.<sup>10</sup> 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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<sup>8</sup> 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.

<sup>9</sup> Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* 242 (2014).

<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup>

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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<sup>11</sup> Gary G. Chandler, *Generic and Customized Scoring Models: A Comparison*, in CREDIT SCORING FOR RISK MANAGERS: THE HANDBOOK FOR LENDERS, (Elizabeth Mays, Ed., 2004).

<sup>12</sup> Gary G. Chandler and Lee E. Parker, *Predictive Value of Credit Bureau Reports*, 11 JOURNAL OF RETAIL BANKING 47 (1989).

<sup>13</sup> 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).

<sup>14</sup> 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.<sup>15</sup> Moreover, risk-based pricing “led to a broader array of loan products available to all risk and income groups.”<sup>16</sup>

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.<sup>17</sup> The lowest-risk customers enjoyed discounts of 8 percentage points on their APR.<sup>18</sup>

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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<sup>15</sup> 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.

<sup>16</sup> See Wendy Edelberg, *Risk-Based Pricing of Interest Rates on Consumer Loans*, 53 JOURNAL OF MONETARY ECONOMICS 2283 (2006).

<sup>17</sup> See Staten, *supra* note 14, at 43.

<sup>18</sup> Mark J. Furletti, *Credit Card Pricing Developments and Their Disclosure*. Federal Reserve Bank of Philadelphia 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.<sup>19</sup> Down payment requirements increased, however, for the highest risk group, resulting in smaller loans and lower default rates.<sup>20</sup>

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

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<sup>19</sup> Liran Einav et al., The Impact of Credit Scoring on Consumer Lending, 44 RAND J. ECON. 249 (2013)

<sup>20</sup> [org/articles.php?doi=10.1257/mac.4.3.153](http://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,<sup>21</sup> 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.<sup>22</sup>

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.<sup>23</sup> 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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<sup>21</sup> See Benjamin Klein. and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 JOURNAL OF POLITICAL ECONOMY 615-641 (1981).

<sup>22</sup> This arrangement also imposes the transaction costs on the parties who benefit from them.

<sup>23</sup> 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<sup>24</sup>

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<sup>25</sup> 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

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<sup>24</sup> 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).

<sup>25</sup> *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.<sup>26</sup> 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."<sup>27</sup> 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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<sup>26</sup> 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.

<sup>27</sup> 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.<sup>28</sup> 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.<sup>29</sup> Clearly, access rights can create significant risks to consumers.

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<sup>28</sup> Eric J. Johnson & Daniel Goldstein, *Do Defaults Save Lives?*, 302 SCI. 1338 (2003)

<sup>29</sup> 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.<sup>30</sup> 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.<sup>31</sup> 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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<sup>30</sup> 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>

<sup>31</sup> 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.”<sup>32</sup> 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.<sup>33</sup> The authors suggest that at least part of this decline was because of

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<sup>32</sup> 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>.

<sup>33</sup> 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.<sup>34</sup>

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.<sup>35</sup> Finally, in many applications the freshness of data is important; stale data may generate “insights” that are no longer correct.<sup>36</sup>

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

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<sup>34</sup> 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).

<sup>35</sup> A persistent problem in machine learning is that algorithms developed using biased data sets will likely faithfully reproduce the biases in the original data.

<sup>36</sup> 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](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.<sup>37</sup> 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.<sup>38</sup> 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.<sup>39</sup> 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."<sup>40</sup>

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.<sup>41</sup>

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<sup>37</sup> 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.

<sup>38</sup> [https://files.consumerfinance.gov/f/documents/cfpb\\_quarterly-consumer-credit-trends\\_report\\_2020-11.pdf](https://files.consumerfinance.gov/f/documents/cfpb_quarterly-consumer-credit-trends_report_2020-11.pdf)

<sup>39</sup> John Koetsier, *Apple Just Crippled IDFA, Sending an \$80 Billion Industry Into Upheaval*, FORBES, June 24, 2020.

<sup>40</sup> 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.

<sup>41</sup> 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.<sup>42</sup> Both Google and Facebook had revenue growth greater than the European digital advertising market growth, implying increases in their market share.<sup>43</sup> Researchers have also found that GDPR increased concentration among the technology vendors who provide services to websites.<sup>44</sup>

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.<sup>45</sup> 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.<sup>46</sup> 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

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<sup>42</sup> 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/>.

<sup>43</sup> Nick Kostov and Sam Schechner, *GDPR Has Been a Boon for Google and Facebook*, THE WALL STREET JOURNAL, June 17, 2019.

<sup>44</sup> 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>

<sup>45</sup> James David Campbell, Avi Goldfarb, and Catherine E. Tucker, *Privacy Regulation and Market Structure*, 24(1) JOURNAL OF ECONOMICS & MANAGEMENT STRATEGY 47 (2015).

<sup>46</sup> See Gal and Aviv, *supra* note 36.

used more.<sup>47</sup> 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.<sup>48</sup>

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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<sup>47</sup> <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/>.

<sup>48</sup> 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.<sup>49</sup> 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.<sup>50</sup>

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<sup>49</sup> 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.

<sup>50</sup> 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.<sup>51</sup> 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.”<sup>52</sup>

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.<sup>53</sup> 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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<sup>51</sup> See RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW*, Section 6.6 (2014).

<sup>52</sup> Restatement (Second) of Torts § 652B (1977) (intrusion upon seclusion); id. § 652D (publicity given to private life); id. § 652E (publicity placing person in false light).

<sup>53</sup> 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.<sup>54</sup> 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."<sup>55</sup> 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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<sup>54</sup> 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>.

<sup>55</sup> 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%.<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup>

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<sup>56</sup> Avi Goldfarb and Catherine Tucker, *Privacy Regulation and Online Advertising*, 57(1) MANAGEMENT SCIENCE (2011), 51-71.

<sup>57</sup> 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/fullvalueinfofstudy.pdf>, January, 2014.

<sup>58</sup> 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 PIN, 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.<sup>59</sup> 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

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<sup>59</sup> 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”<sup>60</sup> 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.”<sup>61</sup>

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.<sup>62</sup> Social Security Numbers (SSN) are subject to transposition

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<sup>60</sup> FTC Report to Congress under Sections 318 and 319 of the FACT Act of 2003, at 7 (December 2004).

<sup>61</sup> 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>.

<sup>62</sup> 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.<sup>63</sup>

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.<sup>64</sup> 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.<sup>65</sup>

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<sup>63</sup> 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>.

<sup>64</sup> CFPB, SUPERVISORY HIGHLIGHTS; CONSUMER REPORTING SPECIAL EDITION (2017) [https://files.consumerfinance.gov/f/documents/201703\\_cfpb\\_Supervisory-Highlights-Consumer-Reporting-Special-Edition.pdf](https://files.consumerfinance.gov/f/documents/201703_cfpb_Supervisory-Highlights-Consumer-Reporting-Special-Edition.pdf)

<sup>65</sup> 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.<sup>66</sup> 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.

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<sup>66</sup> 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.<sup>67</sup> 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.<sup>68</sup> 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.<sup>69</sup> 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.<sup>70</sup> 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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<sup>67</sup> The CFPB Office of Research, *Data Point: Credit Invisibles*, 16 (2015) ([https://files.consumerfinance.gov/f/201505\\_cfpb\\_data-point-credit-invisibles.pdf](https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf))

<sup>68</sup> 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/>.

<sup>69</sup> 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](https://www.hud.gov/press/press_releases_media_advisories/HUD_No_20_030)

<sup>70</sup> 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.<sup>71</sup>

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.”<sup>72</sup>

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<sup>71</sup> Id.

<sup>72</sup> 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.<sup>1</sup> The NCCF maintained that consumers who lack understanding of financial products may not be able to obtain the full benefits of a

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<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup>

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.<sup>4</sup> 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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<sup>2</sup> 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).

<sup>3</sup> 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).

<sup>4</sup> 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](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.<sup>5</sup> 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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<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

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<sup>6</sup> 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).

<sup>7</sup> 12 U.S.C. §5493(d).

<sup>8</sup> Bureau of Consumer Financial Protection, Financial Literacy Annual Report (Dec. 2019).

<sup>9</sup> Consumer Financial Protection Bureau, Financial Well-Being: The Goal of Financial Education (Jan. 2015).

<sup>10</sup> 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/](http://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.<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup>

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 20<sup>th</sup>

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<sup>10</sup> 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/](http://www.councilforeconed.org/survey-of-the-states-2020/).

<sup>11</sup> 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.

<sup>12</sup> 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).

<sup>13</sup> *Id.* Interest in reverse mortgages by older consumers has also stimulated growth in homeownership counseling.

century.<sup>14</sup> 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.<sup>15</sup> 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

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<sup>14</sup> Robert M. Hunt, *Whither Consumer Credit Counseling?*, Federal Reserve Bank of Philadelphia Business Rev. 9 (Fourth Quarter 2005).

<sup>15</sup> *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.”<sup>16</sup> 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.<sup>17</sup>

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.<sup>18</sup> 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.<sup>19</sup> 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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<sup>16</sup> 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>.

<sup>17</sup> 20 U.S.C. § 9703(f).

<sup>18</sup> 20 U.S.C. § 9703(a)(1).

<sup>19</sup> 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.<sup>20</sup> 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.<sup>21</sup> 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.<sup>22</sup>

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

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<sup>20</sup> 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).

<sup>21</sup> Lusardi and Mitchell, *Economic Importance*, *supra* note 20.

<sup>22</sup> See Annamaria Lusardi 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).<sup>23</sup> Responses to these questions by other population groups produced similar large percentages of individuals who were unable to provide correct answers.<sup>24</sup> 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.<sup>25</sup> 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

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<sup>23</sup> 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.

<sup>24</sup> 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).

<sup>25</sup> 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.<sup>26</sup> 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.

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<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup>

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

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<sup>27</sup> 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.

<sup>28</sup> 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.<sup>29</sup> 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.<sup>30</sup>

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

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<sup>29</sup> 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.

<sup>30</sup> 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 findings 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.<sup>31</sup> 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.<sup>32</sup> 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

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<sup>31</sup> Some of the interventions in Miller et al.'s study were interventions outside the US. See Miller et al., *supra* note 28.

<sup>32</sup> Kaiser and Menkoff, *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.<sup>33</sup> 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.<sup>34</sup> 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.<sup>35</sup> 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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<sup>33</sup> Kaiser, et al., *Financial Education*, *supra* note 3.

<sup>34</sup> *Id.* at 3.

<sup>35</sup> *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.<sup>36</sup> 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.<sup>37</sup>

Financial education interventions appear to be more effective for some types of behavior (saving and budgeting) than others (credit use and payment behavior).<sup>38</sup> Saving and budgeting may become routine and thus require minimal ongoing cognitive effort or conscious attention. In

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<sup>36</sup> Jing Jian Xiao and Barbara O'Neill, Mental Accounting and Behavioural Hierarchy: Understanding Consumer Budgeting Behaviour, 42 Intl. J. Consumer Studies 448 (2018).

<sup>37</sup> Liat Hadar, Sanjay Sood, and Craig R. Fox, *Subjective Knowledge in Consumer Financial Decisions*, 50 J. Marketing Res. 303 (2013).

<sup>38</sup> 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.<sup>39</sup> According to this literature, consumers often use heuristics (rules of thumb) to simplify decisions but are error-prone.<sup>40</sup> 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.<sup>41</sup> 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.<sup>42</sup> Financial education interventions informed by understanding

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<sup>39</sup> 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).

<sup>40</sup> 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).

<sup>41</sup> Gerd Gigerenzer, Peter M. Todd, and the ABC Research Group, *Simple Heuristics that Make Us Smart* (1999).

<sup>42</sup> Gerd Gigerenzer and Henry Brighton, *Homo Heuristicus: Why Biased Minds Make Better Inferences*, 1Topics in Cognitive Science 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.<sup>43</sup>

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

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<sup>43</sup> 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,<sup>44</sup> 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.<sup>45</sup> 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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<sup>44</sup> 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).

<sup>45</sup> 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.<sup>46</sup> 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.<sup>47</sup> The Covid pandemic has accelerated this migration by millennials out of large cities.<sup>48</sup> 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.<sup>49</sup> 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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<sup>46</sup> 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).

<sup>47</sup> 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>.

<sup>48</sup> 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/>.

<sup>49</sup> 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.<sup>50</sup> 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).<sup>51</sup> 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.<sup>52</sup>

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.<sup>53</sup> Net wealth generally increased more rapidly for younger households during this period as well.<sup>54</sup> 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.<sup>55</sup>

This recent economic success (prior to the 2020 Covid pandemic) reversed a downward trend from 2001-2013 in net worth among younger consumers.<sup>56</sup> The decline in net worth during this

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<sup>50</sup> 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/>.

<sup>51</sup> Pew Research Center, *Worries About Coronavirus Surge, as Most Americans Expect a Recession—or Worse* (Mar. 25, 2020).

<sup>52</sup> 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).

<sup>53</sup> See Neil Bhutta, Jesse Bricker, Andrew C. Chang, Lisa J. Dettling, Sarena Goodman, Joanne W. Hsu, Keven B. Moore, Sarah Reber, Alice Henriques 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).

<sup>54</sup> *Id.* at 11, Table 2.

<sup>55</sup> 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).

<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup> 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.<sup>59</sup> 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.<sup>60</sup> 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.<sup>61</sup> 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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<sup>57</sup> *Id.* at 313. This decline, however, mirrored the decline in home ownership by older households during this period.

<sup>58</sup> 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/>.

<sup>59</sup> 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.

<sup>60</sup> 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>; Jason 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>.

<sup>61</sup> 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.”<sup>62</sup> 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.<sup>63</sup>

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.<sup>64</sup> 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.<sup>65</sup> 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.<sup>66</sup> 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).<sup>67</sup>

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.<sup>68</sup> 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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<sup>62</sup> 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>.

<sup>63</sup> See *id.* at 40.

<sup>64</sup> Sylvain Catherine and Constantine Yannelis, *The Distributional Effects of Student Loan Forgiveness*, NBER Working Paper 28175, <http://www.nber.org/papers/w28175> (Dec. 2020).

<sup>65</sup> 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).

<sup>66</sup> See Federal Reserve Bank of New York, *Student Loan Debt by Age Group* (Mar. 29, 2013).

<sup>67</sup> Federal Reserve Bank of New York, *Non-Housing Debt Balance*, Newyorkfed.org, <https://www.newyorkfed.org/microeconomics/hhdc.html>.

<sup>68</sup> 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.<sup>69</sup> Many high-balance borrowers attended graduate school where they accumulated large balances.<sup>70</sup> In general, both the number of consumers with student loans and their student loan balances upon graduation have been increasing over time.<sup>71</sup> 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.<sup>72</sup> 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).<sup>73</sup>

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<sup>74</sup>**

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<sup>69</sup> See Catherine and Yannelis, *supra* note 64, at 8.

<sup>70</sup> See Chakrabarti, Et al., *supra* note 62, at 20.

<sup>71</sup> *Id.* at 21.

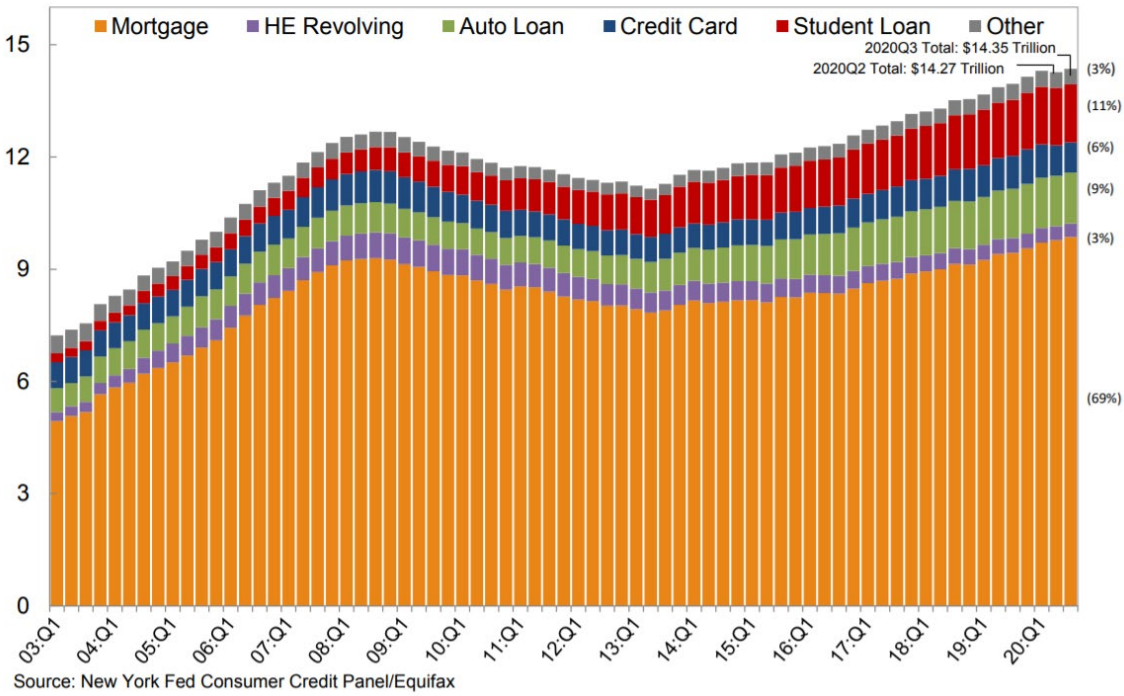
<sup>72</sup> Andrew Haughwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, *Just Released: Racial Disparities in Student Loan Outcomes*, Liberty Street Economics (Nov. 13, 2019), available in <https://libertystreeteconomics.newyorkfed.org/2019/11/just-released-racial-disparities-in-student-loan-outcomes.html>.

<sup>73</sup> Catherine and Yannelis, *supra* note 64, at 12.

<sup>74</sup> Source: Federal Reserve Bank of New York.



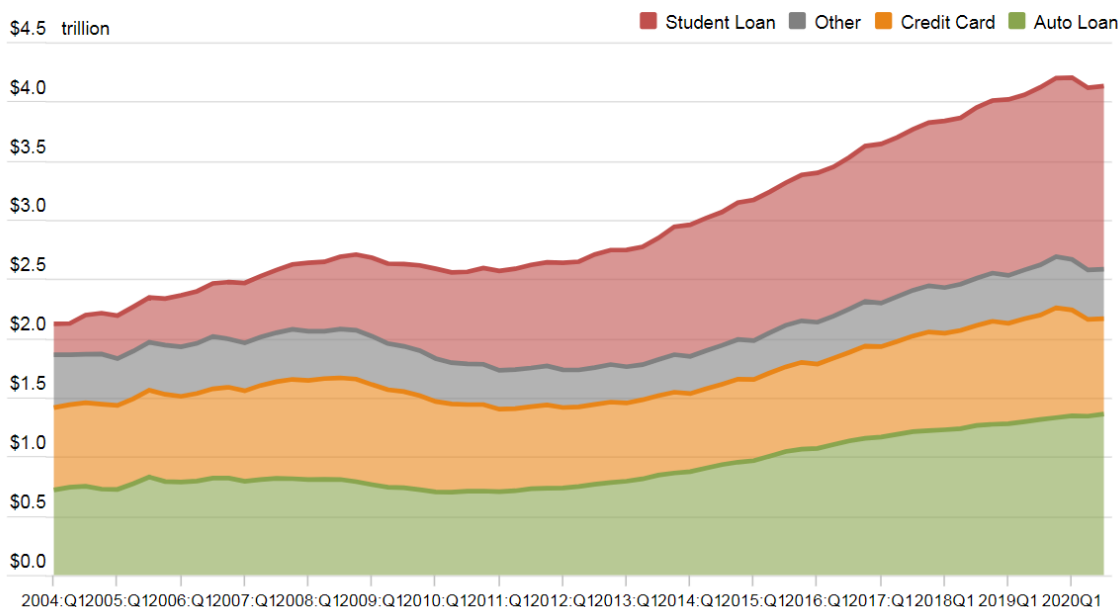
Trillions of Dollars



**FIGURE 12-2:** HOUSEHOLD DEBT HOLDING BY CATEGORY, CONSUMER NON-MORTGAGE DEBT<sup>75</sup>

<sup>75</sup> 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.<sup>76</sup> This negative relationship between college debt and homeownership appears to be only a short-run phenomenon.<sup>77</sup> 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 homeownership 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,

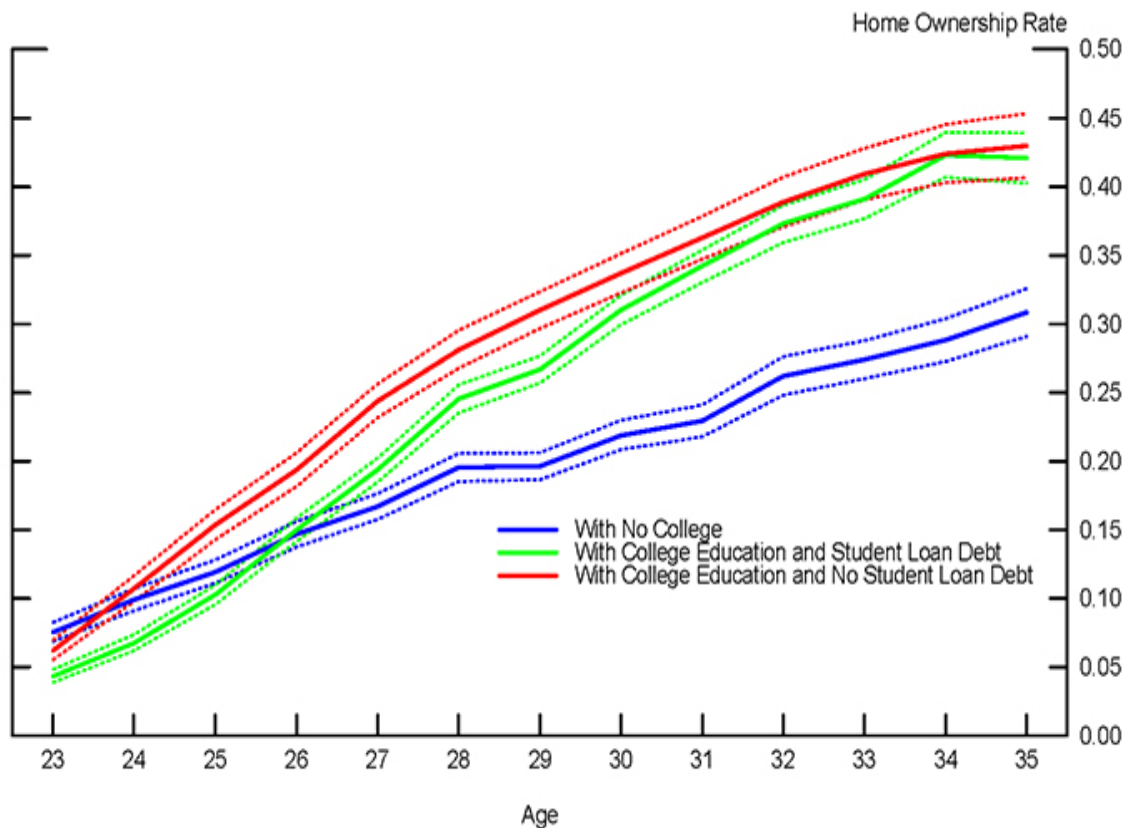
<sup>76</sup> See Alvaro Mezza, Daniel Ringo, Shane Sherlund, and Kamila Sommer, *On the Effect of Student Loans on Access to Homeownership*, Federal Reserve Board (Mar. 2, 2016).

<sup>77</sup> 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.<sup>78</sup> 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.

<sup>78</sup> 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<sup>79</sup> unless the mortgage can qualify under the Temporary GSE qualified mortgage exception<sup>80</sup>. As income rises and student loan debt balances are paid down, however, it might be that one's DTI declines sufficiently to qualify.<sup>81</sup> 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.<sup>82</sup>

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.<sup>83</sup> 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.<sup>84</sup> 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.

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<sup>79</sup> 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.

<sup>80</sup> Bureau of Consumer financial Protection, Ability-to-Repay and Qualified Mortgage Assessment Report (Jan. 2019).

<sup>81</sup> 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).

<sup>82</sup> 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).

<sup>83</sup> 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).

<sup>84</sup> 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.<sup>85</sup> 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.<sup>86</sup> In addition, tuition and other college costs have increased for all types of institutions, regardless of whether they are private or public institutions.<sup>87</sup> 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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<sup>85</sup> 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).

<sup>86</sup> 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>.

<sup>87</sup> 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 LOAN 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.<sup>88</sup> Default rates in Black-Majority areas are also higher than default rates in White neighborhoods.<sup>89</sup>

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.

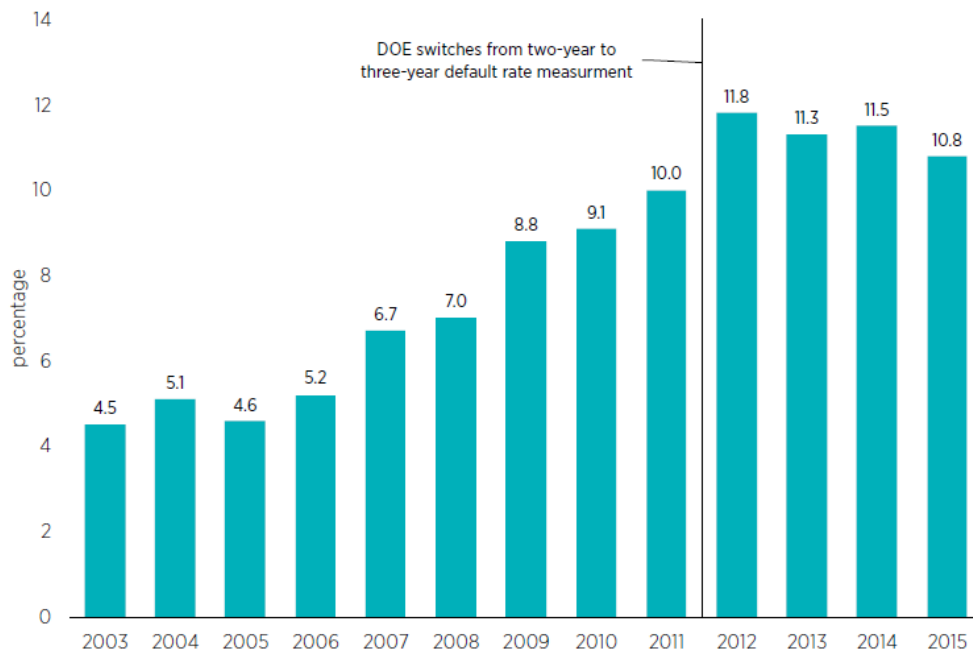
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<sup>88</sup> See Andrew F. Haughtwout, Donghoon Lee, Joelle Scally, and Wilbert van der Klaauw, *Just Released: Mind the Gap in Delinquency Rates*, Liberty Street Economics (Aug. 13, 2019), available in <https://libertystreeteconomics.newyorkfed.org/2019/08/just-released-mind-the-gap-in-delinquency-rates.html>.

<sup>89</sup> Andrew Haughtwout, 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<sup>90</sup>

### Student Loan Default Rate, 2003–2015



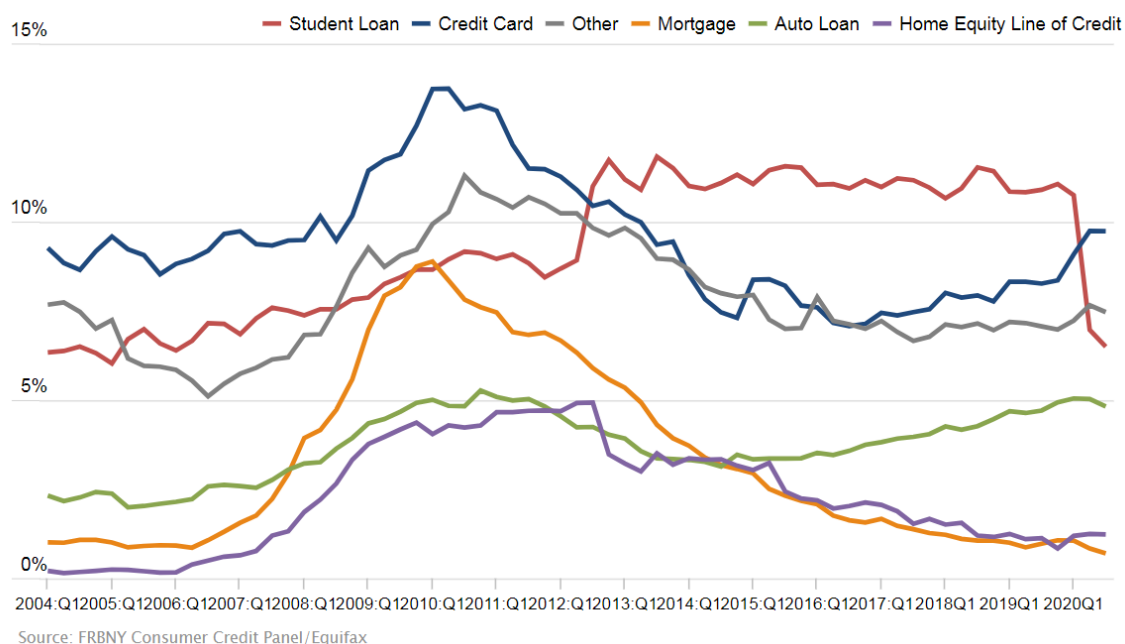
Since then, default rates have remained relatively constant and have stabilized at a rate much higher than the delinquency rates on other types of consumer loans—except for a temporary drop in reported delinquencies as a result of pandemic-related collections and reporting forbearance beginning in the second quarter of 2020—as shown in Figure 12-5.<sup>91</sup>

<sup>90</sup> 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>.

<sup>91</sup> 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<sup>92</sup>**

## Percent of Balance 90+ Days Delinquent



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.<sup>93</sup> 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.<sup>94</sup> 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

<sup>92</sup> Source: Federal Reserve Bank of New York.

<sup>93</sup> 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>.

<sup>94</sup> *Id.* at 30.

they left school compared to borrowers from higher-income areas, who have paid down nearly 30 percent of their balances.<sup>95</sup>

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.<sup>96</sup> 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.<sup>97</sup> 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."<sup>98</sup> Another summary concluded, "Defaulters are more likely to be older, be Pell Grant recipients, and come from underrepresented backgrounds than those who never default."<sup>99</sup>

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<sup>95</sup> *Id.* at 32.

<sup>96</sup> 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).

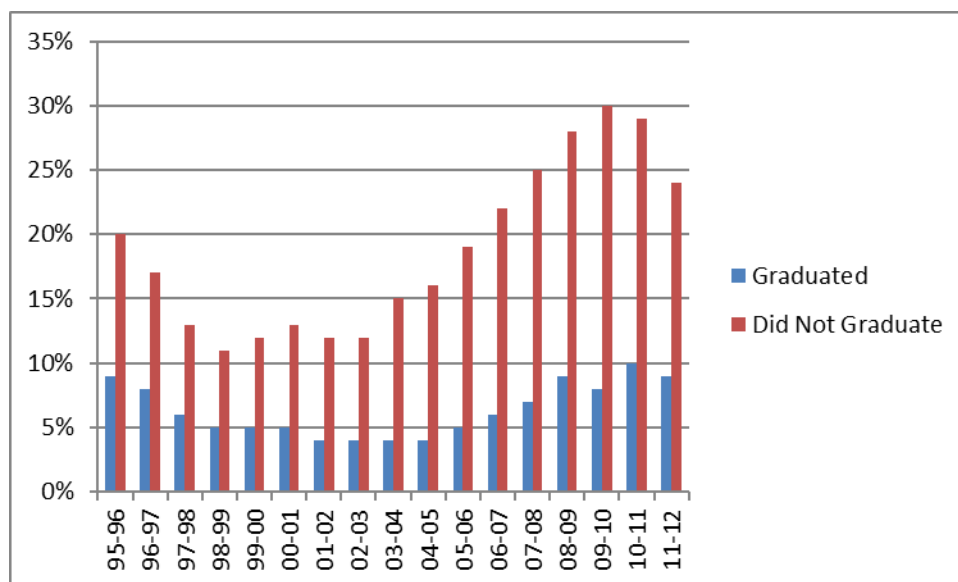
<sup>97</sup> Alvaro Mezza and Kamila Sommer, A Trillion Dollar Question: What Predicts Student Loan Delinquency Risk?, FEDS Notes (Oct. 16, 2015).

<sup>98</sup> *Id.* at 27.

<sup>99</sup> 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.<sup>100</sup> 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.<sup>101</sup> 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.<sup>102</sup> 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.**<sup>103</sup>



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

<sup>100</sup> 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.

<sup>101</sup> See Mezza and Sommer, *supra* note 97.

<sup>102</sup> See William G. Bowen, Matthew M. Chingos, and Michael S. McPherson, *Crossing the Finish Line: Completing College At America's Public Universities* (2009).

<sup>103</sup> Source: The College Board.



college) that a student attends does not have a discernible effect on default rates.<sup>104</sup> 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.<sup>105</sup> 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.<sup>106</sup> 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.<sup>107</sup> 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.<sup>108</sup>

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.<sup>109</sup> 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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<sup>104</sup> 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.”).

<sup>105</sup> *See 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>

<sup>106</sup> *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/>.

<sup>107</sup> Mezza and Sommer, *supra* note 97.

<sup>108</sup> 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](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).

<sup>109</sup> *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.”<sup>110</sup> 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.<sup>111</sup> 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.

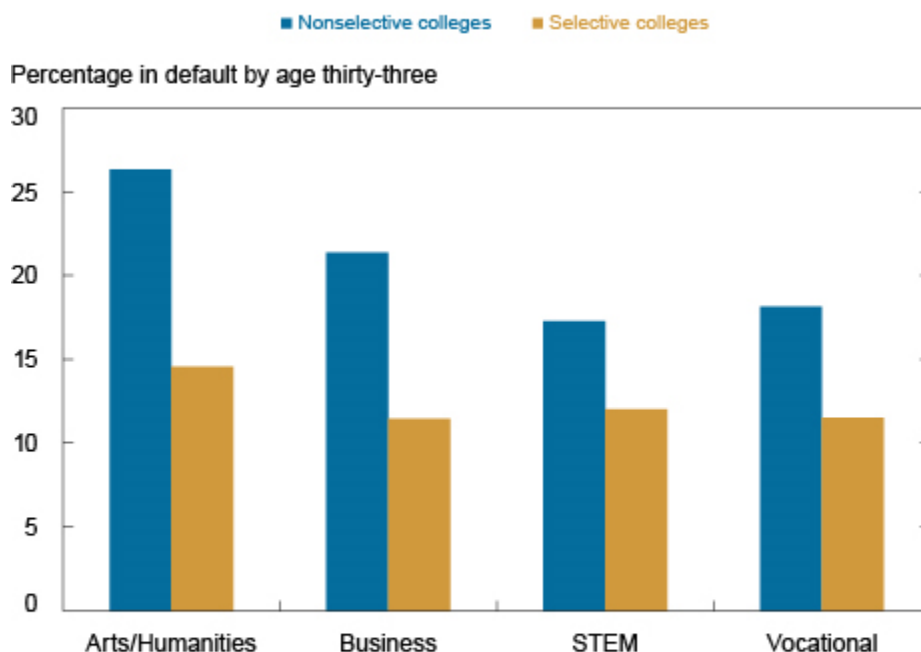
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<sup>110</sup> See Looney and Yannellis, *supra* note 104, at 64; See Adam Looney and Constantine Yannellis, *Borrowers with Large Balances: Rising Student Debt and Falling Repayment Rates*, Brookings Institution (Feb. 2018).

<sup>111</sup> See Looney and Yannellis, *supra* note 104.

**FIGURE 12-7:** STUDENT LOAN DEFAULT RATES BY COLLEGE SELECTIVITY AND MAJOR<sup>112</sup>

### Student Loan Default Rates by College Selectivity and Major



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 Yannelis 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."<sup>113</sup> For policy purposes, the challenge is that marginal and

<sup>112</sup> Source: New York Federal Reserve Bank

<sup>113</sup> 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.<sup>114</sup> 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.<sup>115</sup>

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

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<sup>114</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3376245).

<sup>115</sup> 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.<sup>116</sup> 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.<sup>117</sup> One possible compromise would be to cap student loan

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<sup>116</sup> See Catherine and Yannelis, *supra* note 64.

<sup>117</sup> 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.<sup>118</sup>

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.<sup>119</sup> 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.<sup>120</sup> 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.

<sup>118</sup> See Beth Akers, *Forgive Student Loans, but Only a Little*, Wall St. J. p. A15 (Nov. 23, 2020).

<sup>119</sup> 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").

<sup>120</sup> 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.”<sup>121</sup>

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 20<sup>th</sup> 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*

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<sup>121</sup> Looney and Yanellis, *supra* note 104, at 64.

*Minneapolis v. First of Omaha Service Corp.*,<sup>122</sup> 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.<sup>123</sup>

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<sup>122</sup> 439 U.S. 299 (1978).

<sup>123</sup> 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.<sup>124</sup> Members of the millennial and Generation X generations are substantially less likely to use cash for transactions than other

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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](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).

<sup>124</sup> 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.<sup>125</sup> 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.<sup>126</sup> General purpose reloadable prepaid cards are also popular with millennials.<sup>127</sup> 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.<sup>128</sup>

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.<sup>129</sup> Gen Z'ers are especially likely to use digital wallets<sup>130</sup> and to conduct peer-to-peer money transfers.<sup>131</sup> 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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<sup>125</sup> See Kim, et al., *supra* note 124; Kumar, *supra* note 124.

<sup>126</sup> 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).

<sup>127</sup> 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/>.

<sup>128</sup> See discussion in Section II.D., *infra*.

<sup>129</sup> 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>.

<sup>130</sup> 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>.

<sup>131</sup> 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.<sup>132</sup>

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.<sup>133</sup> 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.<sup>134</sup> 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.<sup>135</sup> 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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<sup>132</sup> Id.

<sup>133</sup> 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).

<sup>134</sup> 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>.

<sup>135</sup> 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.<sup>136</sup> 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.”<sup>137</sup> 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.<sup>138</sup> 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.<sup>139</sup> 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.<sup>140</sup> 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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<sup>136</sup> See Kim, *supra* note 124.

<sup>137</sup> 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>.

<sup>138</sup> See Manole, *What Gen-Z Thinks*, *supra* note 134.

<sup>139</sup> 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).

<sup>140</sup> 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.<sup>141</sup> Indeed, Generation Z consumers are increasingly using a novel innovation known as “online cash” to conduct transactions.<sup>142</sup> 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.<sup>143</sup> 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.<sup>144</sup> 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.<sup>145</sup> Another study found that 79 percent of one-dollar bills contained traces of cocaine.<sup>146</sup> Coins can also be robust transmitters of bacteria and disease—one study found that penicillin-resistant bacteria can survive on coins.<sup>147</sup> 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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<sup>141</sup> Kim, *supra* note 124.

<sup>142</sup> 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/>.

<sup>143</sup> 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).

<sup>144</sup> See Manole, *What Gen-Z Thinks*, *supra* note 134.

<sup>145</sup> 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).

<sup>146</sup> Jonathan Oyler, William D. Darwin, Edward J. Cone, *Cocaine Contamination of United States Paper Currency*, 20 J. of Analytical Toxicology 213 (1996).

<sup>147</sup> 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.<sup>148</sup>

## 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.<sup>149</sup> 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.<sup>150</sup>

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.<sup>151</sup> 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.<sup>152</sup> Younger consumers are also now more likely to have a co-signed card than before the CARD Act's passage.<sup>153</sup>

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

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<sup>148</sup> 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>.

<sup>149</sup> 15 U.S.C. §1650(f)(2); 15 U.S.C. § 1681b(c)(1)(b).

<sup>150</sup> 15 U.S.C. §1637(c)(8); 12 C.F.R. §1026.51(b)(1).

<sup>151</sup> See United States Government Accountability Office, Report to Congressional Committees, Credit Cards: Marketing to College Students Appears to Have Declined (Feb. 2014).

<sup>152</sup> 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).

<sup>153</sup> *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.<sup>154</sup> 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.<sup>155</sup> 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).<sup>156</sup>

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.<sup>157</sup>

A study by economists at the Federal Reserve Bank of Boston confirms the concern that blocking access to credit cards early in life increases the likelihood of a consumer remaining credit invisible later.<sup>158</sup> 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.”<sup>159</sup> 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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<sup>154</sup> See Consumer Financial Protection Bureau, Data Point: Credit Invisibles (May 2015)

<sup>155</sup> 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/>.

<sup>156</sup> 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).

<sup>157</sup> 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.”).

<sup>158</sup> See Daniel Cooper, Olga Gorbachev, and Maira Jose Luengo-Prado, *Consumption, Credit, and the Missing Young*, Federal Reserve Bank of Boston (Aug. 5, 2020).

<sup>159</sup> *Id.* at 3.

individuals of less privileged backgrounds.”<sup>160</sup> 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.”<sup>161</sup> 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.”<sup>162</sup> 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.<sup>163</sup>

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.<sup>164</sup> 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.<sup>165</sup> 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.<sup>166</sup> Moreover, good performance on credit card accounts can

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<sup>160</sup> Id.

<sup>161</sup> Id.

<sup>162</sup> See Debbaut, et al., *supra* note 152, at 1496.

<sup>163</sup> Cooper, et al., *supra* note 158, at 12.

<sup>164</sup> 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).

<sup>165</sup> 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.

<sup>166</sup> 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.”<sup>167</sup> 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.<sup>168</sup> Writing in 1956 famed social critic William Whyte captured the idea in his iconic “Fortune” magazine essay, “Budgetism: Opiate of the Middle Class.”<sup>169</sup> 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

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<sup>167</sup> 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.

<sup>168</sup> Lendol G. Calder, *Financing the American Dream: A Cultural History of Consumer Credit* (1999).

<sup>169</sup> 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.<sup>170</sup> 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.

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<sup>170</sup> 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.<sup>171</sup> 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<sup>172</sup> or implicit rate of return from the purchase of a household appliance such as a washing machine, automobile, or refrigerator.<sup>173</sup>

As a result, expenditures relative to income are typically much higher early in life than later.<sup>174</sup> Average household spending hits a peak at age forty-five and steadily declines in every category except for healthcare after that.<sup>175</sup> 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.<sup>176</sup>

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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<sup>171</sup> Zywicki, *supra* note 170, at 904-06.

<sup>172</sup> See discussion above estimating the rate of return for investments in higher education to be approximately double that of financial investments.

<sup>173</sup> See Chapter 3.

<sup>174</sup> Albert Ando and Franco Modigliani, The “Life Cycle” Hypothesis of Savings: Aggregate Implications and Tests, 53 *Am. Econ. Rev.* 55 (1963).

<sup>175</sup> See S. Katherine Roy, Sparking Better Retirement Conversations and Outcomes, JP Morgan Funds (Jan. 2014).

<sup>176</sup> 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.<sup>177</sup> Those between 25-34 years of age spend 70.8 percent of their total income.<sup>178</sup> As households reach middle age (45-54 years old) they spend on 64.6 percent of their income.<sup>179</sup> 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<sup>180</sup> and after making their final mortgage payment.<sup>181</sup> 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.<sup>182</sup>

## 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.<sup>183</sup> To increase income, however, requires working more hours—i.e., increasing labor and reducing leisure.

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<sup>177</sup> 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).

<sup>178</sup> *Id.* People in this age bracket have average total income of \$69,062, spend \$48,928, and save \$12,218.

<sup>179</sup> *Id.* These households save almost 20 percent of their income.

<sup>180</sup> 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).

<sup>181</sup> Brahim 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).

<sup>182</sup> See Taha Choukhmane, *Default Options and Retirement Saving Dynamics*, working paper (Jan. 2, 2019).

<sup>183</sup> 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.<sup>184</sup> Seventy-five percent of Americans “don’t get enough sleep” relative to recommended levels.<sup>185</sup> Five percent of the working population already works two jobs.<sup>186</sup> Ninety-five percent of workers wish that they could spend more time with their families<sup>187</sup> and 76 percent of women say they wish they had more time in the day to get things done<sup>188</sup>. Seventy-five percent of single parents who work full time wish that they had more time available to spend with their children.<sup>189</sup> Many people also would like to engage in volunteer activities more often but blame a lack of time for their inability to do so.<sup>190</sup> The most frequently expressed reason for why people do not exercise more is lack of time.<sup>191</sup>

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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<sup>184</sup> *Id.* at 908.

<sup>185</sup> *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>.

<sup>186</sup> 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](https://www.census.gov/newsroom/releases/archives/facts_for_features_special_editions/cb10-ff15.html).

<sup>187</sup> See Kerby Anderson, *Making the Most of Your Money in Tough Times* 25 (2009).

<sup>188</sup> *Id.*

<sup>189</sup> 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).

<sup>190</sup> See Marc A. Musick & John Wilson, *Volunteers: A Social Profile* 148–49 (2008).

<sup>191</sup> 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](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.”<sup>192</sup>

## 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.<sup>193</sup> 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.<sup>194</sup> 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.<sup>195</sup> 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

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<sup>192</sup> 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).

<sup>193</sup> 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).

<sup>194</sup> 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.*

<sup>195</sup> 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.<sup>196</sup>

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.<sup>197</sup> 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.<sup>198</sup>

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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<sup>196</sup> 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](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.

<sup>197</sup> 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).

<sup>198</sup> *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.<sup>199</sup>

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.<sup>200</sup> 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.<sup>201</sup> 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<sup>202</sup>

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.<sup>203</sup> 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.<sup>204</sup> Moreover, 86 percent of workers who change jobs (usually because they were fired)

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<sup>199</sup> Transamerica Center for Retirement Savings, 16<sup>th</sup> 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](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.

<sup>200</sup> TIAA-CREF, *Should You Borrow Against Your Retirement Plan?*, <https://www.tiaa-cref.org/public/advice-guidance/saving-for-retirement/borrow-from-retirement-plan>.

<sup>201</sup> Interest payments are made to oneself.

<sup>202</sup> 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.

<sup>203</sup> 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).

<sup>204</sup> 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.<sup>205</sup> 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.<sup>206</sup>

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.<sup>207</sup> 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.<sup>208</sup> 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.<sup>209</sup> Average net worth of older household is higher than for any other age group.<sup>210</sup> In addition, between 2000 and 2011, income among 70 year olds increased across all income brackets with income increasing faster

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<sup>205</sup> Lu, et al., *supra* note 203.

<sup>206</sup> Lu, et al., *supra* note 203.

<sup>207</sup> 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).

<sup>208</sup> See Ilana Boivie and Nari Rhee, *The Continuing Retirement Savings Crisis* (National Institute for Retirement Security, Mar. 2015).

<sup>209</sup> See Jessica Semega, Melissa Kollar, John Creamer, and Abinash Mohanty, *Income and Poverty in the United States: 2018* at 15, Fig. 10 (June 2020).

<sup>210</sup> See Neil Bhutta, Jesse Bricker, Andrew C. Chang, Lisa J. Dettling, Sarena Goodman, Joanne W. Hsu, Keven B. Moore, Sarah Reber, Alice Henriques 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.<sup>211</sup> Other researchers have also found high levels of income and financial security among older Americans and low levels of poverty.<sup>212</sup> 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.<sup>213</sup> Overall, only 4 percent of retirees in 2018 said that they were “finding it difficult to get by.”<sup>214</sup>

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 5<sup>th</sup> percentile of retirees than at the 95<sup>th</sup> percentile of the working-age population.<sup>215</sup> 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.<sup>216</sup> 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.<sup>217</sup> 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.<sup>218</sup> 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.<sup>219</sup> In part, however, lower level of private retirement savings among lower-income households

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<sup>211</sup> See John Beshears, James Choi, David Laibson, and Shanthi Ramnath, *Trends in Retirement Income Adequacy*, NBER Working Paper 19-06 (Aug. 2019).

<sup>212</sup> 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>.

<sup>213</sup> 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).

<sup>214</sup> See Andrew Biggs, *Rising Retiree Bankruptcies? It's a Myth*, Washington Examiner (Sept. 6, 2019) (citing Federal Reserve data).

<sup>215</sup> *Id.*

<sup>216</sup> 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>.

<sup>217</sup> 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>.

<sup>218</sup> Biggs, *Stop Pushing*, *supra* note 216.

<sup>219</sup> *Id.* (Recent research by economists at the Internal Revenue Service 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.<sup>220</sup>

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.<sup>221</sup> 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.<sup>222</sup>

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.<sup>223</sup> 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.<sup>224</sup> 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.<sup>225</sup> 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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<sup>220</sup> See Biggs, *Stop Pushing*, *supra* note 216.

<sup>221</sup> See Bhutta, *supra* note 210, at 14-15, Box 3.

<sup>222</sup> Presumably this expectation of receiving a bequest affects the incentives of the presumed heirs to save from their own income as well.

<sup>223</sup> 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).

<sup>224</sup> 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](https://www.ssc.wisc.edu/~scholz/Research/Are_All_Americans_v6.pdf).

<sup>225</sup> 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.<sup>226</sup>

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.<sup>227</sup> From 1995 to 2018, the share of people aged 55 to 79 who were employed increased from 33 percent to 44 percent.<sup>228</sup> 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.<sup>229</sup>

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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<sup>226</sup> See Zywicki, *supra* note 170, at 911-13 (discussing studies).

<sup>227</sup> 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).

<sup>228</sup> See Congressional Budget Office, *Employment of People Ages 55 to 79* (Sept. 26, 2019).

<sup>229</sup> See *supra* note 192 and accompanying text.

longer (and retiring later) than lower-income households.<sup>230</sup> 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.<sup>231</sup> 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.<sup>232</sup> The decision when to retire is itself determined in large part by the availability of sufficient resources to live comfortably.<sup>233</sup>

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.<sup>234</sup> 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-

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<sup>230</sup> See Transamerica, *supra* note 199, at 58 (finding that 51% of respondents expect to continue working full-time or part-time in retirement).

<sup>231</sup> See *supra* note 180-181 and accompany text (noting that retirement savings increases after children leave home and the mortgage is paid off).

<sup>232</sup> See Zywicki, *supra* note 170, at 891-92.

<sup>233</sup> *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).

<sup>234</sup> See Zywicki, *supra* note 170, at 886-890.

75.<sup>235</sup> 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.<sup>236</sup> “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.”<sup>237</sup> 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.<sup>238</sup>

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.<sup>239</sup> 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.<sup>240</sup>

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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<sup>235</sup> 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>

<sup>236</sup> Sudipto Banerjee, *Expenditure Patterns of Older Americans 2001–2009*, 2012 Emp. Benefit Res. Inst. 368, at 5.

<sup>237</sup> Zywicki, *supra* note 170, at 889 (citing Banerjee, *supra* note 236).

<sup>238</sup> 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/>.

<sup>239</sup> 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).

<sup>240</sup> 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/S004727270800131>.



the plan.<sup>241</sup> Because of their cost, even at their peak, only about 39 percent of employees participated in a defined benefit pension plan.<sup>242</sup> 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.<sup>243</sup> 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.<sup>244</sup> 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.<sup>245</sup>

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.<sup>246</sup> 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.<sup>247</sup> 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

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<sup>241</sup> 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).

<sup>242</sup> See Biggs, *Phony*, *supra* note 213.

<sup>243</sup> See William J. Wiatrowski, *The Last Private Industry Pension Plans: A Visual Essay*, Monthly Labor Rev. 4 (Dec. 2012).

<sup>244</sup> 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>.

<sup>245</sup> 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 who 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).

<sup>246</sup> See Richard A. Ippolito, *Toward Explaining the Growth of Defined Contribution Plans*, 34 Industrial Relations 1 (1995).

<sup>247</sup> 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](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.<sup>248</sup> Eighty percent of *married* couples participate in one of the spouse's retirement plan.<sup>249</sup> 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.<sup>250</sup> 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.<sup>251</sup> 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.<sup>252</sup> Many employers also give *non-matching* contributions to employee retirement plans in addition to

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<sup>248</sup> See Bhutta, *supra* note 210, at 20, Box 6.

<sup>249</sup> 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 participant in a retirement plan and in 10 percent of cases the wife was the only participant.

<sup>250</sup> Bureau of Labor Statistics, *Employee Tenure in 2020* (Sept. 22, 2020), available in <https://www.bls.gov/news.release/pdf/tenure.pdf>.

<sup>251</sup> 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.psc.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>.

<sup>252</sup> 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.<sup>253</sup>

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.*<sup>254</sup>

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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<sup>253</sup> 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>.

<sup>254</sup> 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.<sup>255</sup> The rate of uptake among workers increases substantially when employers offer matching contributions.<sup>256</sup> 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.<sup>257</sup> Approximately 33 percent of families have IRA retirement plans.<sup>258</sup>

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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<sup>255</sup> 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.

<sup>256</sup> Pew, *supra* note 251.

<sup>257</sup> See Transamerica, *supra* note 199, at 31.

<sup>258</sup> 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.”<sup>259</sup> 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.”<sup>260</sup> 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).<sup>261</sup> 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.<sup>262</sup>

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.<sup>263</sup> 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.<sup>264</sup> In the face of rising economic uncertainty, many workers choose to scale back contributions to their retirement accounts and

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<sup>259</sup> See Transamerica, *supra* note 199.

<sup>260</sup> *Id.*

<sup>261</sup> 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/>.

<sup>262</sup> 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.

<sup>263</sup> See Transamerica, *supra* note 199.

<sup>264</sup> 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.<sup>265</sup>

Others are focused on intermediate-term financial goals, such as buying a house.<sup>266</sup> 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.<sup>267</sup> 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.<sup>268</sup> Seven percent took a loan against their retirement account to help pay for college.<sup>269</sup> 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.<sup>270</sup> According to Transamerica's

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<sup>265</sup> 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/>.

<sup>266</sup> 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>.

<sup>267</sup> See Tanza Loudonback, *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>.

<sup>268</sup> Sallie Mae, *How America Pays for College 2020* at 8 (Apr. 27, 2020), available in <https://www.salliemae.com/assets/research/HAP/HowAmericaPaysforCollege2020.pdf>.

<sup>269</sup> *Id.* at 23, Table 1.

<sup>270</sup> 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 participant 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.<sup>271</sup>

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."<sup>272</sup> 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.<sup>273</sup> 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).<sup>274</sup> 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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<sup>271</sup> Transamerica, *supra* note 199.

<sup>272</sup> See Transamerica, *supra* note 199.

<sup>273</sup> *Id.*

<sup>274</sup> 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.<sup>275</sup>

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).<sup>276</sup> 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.<sup>277</sup> 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.<sup>278</sup> 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.<sup>279</sup>

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.<sup>280</sup> This is consistent with a frequently-stressed point throughout this report—family

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<sup>275</sup> Bhutta, *supra* note 210, at 13, Box 2.

<sup>276</sup> See Board of Governors, *supra* note 274, at 21-25 (May 2020).

<sup>277</sup> 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>.

<sup>278</sup> Bhutta and Dettling, *supra* note 277.

<sup>279</sup> *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.

<sup>280</sup> *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.<sup>281</sup> 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.<sup>282</sup> Moreover, minority and less-educated households are more likely than White and more-educated households to report that they are not able to fully pay their current month's bills.<sup>283</sup>

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.<sup>284</sup> Solutions to these problems of insufficient income largely lie outside the consumer financial system.

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<sup>281</sup> 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).

<sup>282</sup> See Board of Governors, *supra* note 274, at 23, Box 3.

<sup>283</sup> See Board of Governors, *supra* note 274, at 24, Fig. 16.

<sup>284</sup> 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”<sup>1</sup> 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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<sup>1</sup> 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.*<sup>2</sup>

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<sup>2</sup> 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.”<sup>3</sup> 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.”<sup>4</sup> 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.”<sup>5</sup> But, the Commission added, “Consumers are entitled to much better consumer credit protection law enforcement at the state level than they have been receiving.”<sup>6</sup> 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.<sup>7</sup> 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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<sup>3</sup> *Id.* at 4.

<sup>4</sup> *Id.* at 57.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 61.

<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

Importantly, neither the Bureau's request for funding nor the Bureau's activities, in general, are subject to the FRB's approval.<sup>10</sup> Congress's appropriations committees also lack the authority to review the Bureau's request for funds.<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup> To summarize the provisions of the CFPA, the primary functions of the Bureau are to:

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<sup>8</sup> See Section 1011(a) of the Dodd-Frank Act.

<sup>9</sup> See *id.* at Section 1017(a).

<sup>10</sup> See *id.* at Section 1012(c)(2).

<sup>11</sup> See *id.* at Section 1017(a)(2)(C).

<sup>12</sup> See *id.* at Section 1017(a)(4).

<sup>13</sup> See *id.* at Section 1017(a)(5)(A).

<sup>14</sup> 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.<sup>15</sup>

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.<sup>16</sup> 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 CFPB consolidates in the Bureau many of the federal consumer protection powers previously held by seven other regulators.<sup>17</sup> 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).<sup>18</sup> 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.<sup>19</sup>

Generally, the CFPB endowed the Bureau with rulemaking authority over federal consumer financial law (with some exceptions contained in Sections 1027 and 1029 of the Dodd-Frank

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<sup>15</sup> See *id.* at Section 1021(c).

<sup>16</sup> See *id.* at Sections 1013(b)-(g).

<sup>17</sup> 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>.

<sup>18</sup> *Id.*

<sup>19</sup> *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.<sup>20</sup> 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.<sup>21</sup>

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.<sup>22</sup> 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.<sup>23</sup>

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.<sup>24</sup> 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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<sup>20</sup> 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).

<sup>21</sup> 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.

<sup>22</sup> See 12 C.F.R. 1090; 12 C.F.R. §1001.

<sup>23</sup> See Section 1022(c)(7) of the Dodd-Frank Act.

<sup>24</sup> See *id.* at Section 1029.



vehicles or boats, as applicable.” But most auto dealers fall outside of this exception, and thus escape Bureau oversight.<sup>25</sup>

### 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.”<sup>26</sup> 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.”<sup>27</sup> 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,<sup>28</sup>
- The Equal Credit Opportunity Act,
- The Fair Credit Billing Act,
- The Fair Credit Reporting Act,<sup>29</sup>
- 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,<sup>30</sup>

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<sup>25</sup> 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).

<sup>26</sup> See Section 1022(a) of the Dodd-Frank Act.

<sup>27</sup> See *id.* at 1002(14).

<sup>28</sup> 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/>.

<sup>29</sup> The CFPA did not transfer to the Bureau authorities under sections 615(e) and 628 of the Fair Credit Reporting Act.

<sup>30</sup> 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.<sup>31</sup>

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.<sup>32</sup> Prescriptive rules provide specific, detailed requirements; whereas principle-based rules describe high-level, broad principles or standards that entities must meet.<sup>33</sup> 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.<sup>34</sup> 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).<sup>35</sup> 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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<sup>31</sup> See *id.* at Section 1002(12).

<sup>32</sup> 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).

<sup>33</sup> See *id.*

<sup>34</sup> 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>.

<sup>35</sup> See Section 1031 of the Dodd-Frank Act.

and “abusive.” The Bureau may undertake rulemaking to further define these standards,<sup>36</sup> but need not do so prior to enforcing them.<sup>37</sup> 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.<sup>38</sup> The Bureau has had to wade into uncharted waters when applying this standard.<sup>39</sup> In February 2020, the Bureau issued a policy intended to clarify the abusiveness standard, but the uncertainty among covered institutions remains.<sup>40</sup>

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.<sup>41</sup> 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.<sup>42</sup> The CFPA also provides the Bureau with the authority to exempt classes of persons or products from a rule or the CFPA.<sup>43</sup> If the Bureau enacts a “significant” rule or order, it is required to assess its effectiveness within the first five years.<sup>44</sup> Beyond this initial assessment, there is no CFPA requirement for the Bureau to continually assess the effectiveness of a rule.<sup>45</sup>

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<sup>36</sup> See Section 1031(b) of the Dodd-Frank Act.

<sup>37</sup> 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.

<sup>38</sup> 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).

<sup>39</sup> See § 8:11. Concurrent Jurisdiction with CFPB, Consumer Protection and the Law § 8:11.

<sup>40</sup> See <https://www.federalregister.gov/documents/2020/02/06/2020-01661/statement-of-policy-regarding-prohibition-on-abusive-acts-or-practices>.

<sup>41</sup> 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.

<sup>42</sup> See *id.* at 1022(b)(2)(A).

<sup>43</sup> See *id.* at Section 1022(b)(2)-(3).

<sup>44</sup> See *id.* at 1022(d).

<sup>45</sup> 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.<sup>46</sup> 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 CFPB establishes the Bureau as the foremost financial regulatory agency conducting examinations for compliance with federal consumer financial law.<sup>47</sup> 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.<sup>48</sup>

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.<sup>49</sup> 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.<sup>50</sup>

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.<sup>51</sup> But the Bureau may require these institutions to provide information

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<sup>46</sup> 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.

<sup>47</sup> *See id.* at Section 1024(d), 1025(b).

<sup>48</sup> *See id.* at Section 1024(b)(1), 1025(b)(1).

<sup>49</sup> *See id.* at Section 1024(b)(3), 1025(e).

<sup>50</sup> *See id.* at Section 1024(b)(2).

<sup>51</sup> *See id.* at Section 1026(d).

to assist in the Bureau's work<sup>52</sup> and may also participate in exams by prudential regulators on a limited basis.<sup>53</sup>

### 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.<sup>54</sup> 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.<sup>55</sup> The Bureau may also recover costs associated with pursuing an action against a violator. However, it cannot recover exemplary or punitive damages.<sup>56</sup>

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.<sup>57</sup> 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.<sup>58</sup> The Bureau has the authority to compromise, modify, or remit any penalty a court or the Bureau assesses.<sup>59</sup> 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.<sup>60</sup>

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<sup>52</sup> See *id.* at Section 1026(b).

<sup>53</sup> See *id.* at Section 1026(c)(1).

<sup>54</sup> See Adam J. Levitin, *The Consumer Financial Protection Bureau: An Introduction*, 32 REV. BANKING & FIN. L. at 357.

<sup>55</sup> See Section 1055(a)(2) of the Dodd-Frank Act.

<sup>56</sup> See *id.* at 1055(a)(3).

<sup>57</sup> See Consumer Financial Protection Bureau, *Office of Enforcement Policies and Procedures Manual*, V. 3.0 (2017).

<sup>58</sup> The current penalties are: Tier 1 - \$5,883; Tier 2 - \$29,416; and Tier 3 - \$1,176,638. See 12 C.F.R. 1033.

<sup>59</sup> See Section 1055(c) of the Dodd-Frank Act.

<sup>60</sup> 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.<sup>61</sup>

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 could arguably generate maximum penalties out of proportion to any harm to consumers.<sup>62</sup> 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.<sup>63</sup> 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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<sup>61</sup> See *id.* See also Section 1055(c)(3) of the Dodd-Frank Act.

<sup>62</sup> Most enforcement actions are settled, not litigated. But both litigated and settled cases are subject to mitigation review.

<sup>63</sup> 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 CFPB 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. Critics argue that 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.<sup>64</sup> 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.<sup>65</sup> Both of these limitations are subject to certain restrictions.<sup>66</sup>

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

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<sup>64</sup> See Section 1027(a)(1) of the Dodd-Frank Act.

<sup>65</sup> See *id.* at Section 1027(a)(2).

<sup>66</sup> See *id.* at Section 1027(a)(2)(A).

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.<sup>67</sup>

Furthermore, the Bureau generally cannot exercise its authority over the solicitation or making of voluntary contributions to certain tax-exempt organizations.<sup>68</sup> 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”).<sup>69</sup> 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.”<sup>70</sup> It also does not have authority to impose a usury limit on an extension of credit.<sup>71</sup>

### 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*.<sup>72</sup> Since its inception, there have been numerous challenges to the Bureau’s structure.<sup>73</sup> 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

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<sup>67</sup> See *id.* at Section 1027.

<sup>68</sup> See *id.* at Section 1027(l).

<sup>69</sup> See Sections 220, 223, 401(a), 403(a), 403(b), 408, 408A, 529, or 530 of the Internal Revenue Code of 1986.

<sup>70</sup> See Section 1027(m) of the Dodd-Frank Act.

<sup>71</sup> See *id.* at Section 1027(o).

<sup>72</sup> See *Seila Law LLC v. Consumer Fin. Prot. Bureau*, 140 S. Ct. 2183 (2020).

<sup>73</sup> § 6:1.Enforcement, Prac. Guide to Consumer Fin. Protection Bureau Regs. § 6:1.



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 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.<sup>74</sup> 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.<sup>75</sup> The Court determined that the President's ability to exercise removal power "is the rule, and not the exception."<sup>76</sup>

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."<sup>77</sup> 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,<sup>78</sup>" 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.<sup>79</sup> 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.<sup>80</sup> 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.<sup>81</sup> In

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<sup>74</sup> See *Seila Law*, 140 S. Ct. 2183.

<sup>75</sup> See *id.* at 2197.

<sup>76</sup> See *id.* at 2190.

<sup>77</sup> See *id.* at 2197.

<sup>78</sup> See *id.* at 2198.

<sup>79</sup> 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.

<sup>80</sup> See *id.* at 2198-99.

<sup>81</sup> See *U.S. v. Perkins*, 6 S. Ct. 449 (1886); *Morrison v. Olson*, 108 S.Ct. 2597 (1988).

*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 authority.<sup>82</sup> 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.<sup>83</sup>

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.<sup>84</sup> The Court found that the Director's for-cause removal restriction impeded the President's ability to perform essential functions contrary to *Humphrey's Executor* and *Morrison*. 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."<sup>85</sup>

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.<sup>86</sup> 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.

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<sup>82</sup> See *Morrison*, 108 S.Ct. 2597.

<sup>83</sup> *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.").

<sup>84</sup> See *id.* at 2199.

<sup>85</sup> *Id.* at 2210-2211.

<sup>86</sup> 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-marshaw/>.

*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 independent agency headed by a multimember board or commission.”<sup>87</sup> 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.’”<sup>88</sup> 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.<sup>89</sup> The Court concluded that an independent agency led by a single director and vested with significant executive power was unconstitutional.

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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.<sup>91</sup> On the other hand, commenters have argued that the power of the President to

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<sup>87</sup> *Seila Law*, 140 S. Ct. at 2191.

<sup>88</sup> *See id.* at 2192.

<sup>89</sup> 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)

<sup>90</sup> *See id.* at 773.

<sup>91</sup> *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%20Agencies%202d%20ed.%20508%20Compliant.pdf>.

remove the head or heads of an agency is the *sine qua non* of an agency's constitutionality, being both necessary and sufficient.<sup>92</sup>

*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*."<sup>93</sup> 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.<sup>94</sup> 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.<sup>95</sup>

### 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.<sup>96</sup> 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.<sup>97</sup> In 2015, Senator Bob Casey sent a letter to the Bureau urging it to investigate

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<sup>92</sup> See Neomi Rao, *Removal: Necessary and Sufficient for Presidential Control*, 65 Ala. L. Rev. 1205, 1227 (2014).

<sup>93</sup> See *Seila Law*, 140 S. Ct. at 2200-01.

<sup>94</sup> See *id.* at 2208.

<sup>95</sup> See *id.*

<sup>96</sup> See e.g. [https://www.huffpost.com/entry/rent-a-center-cfpb-richard-cordray\\_n\\_1250033](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.

<sup>97</sup> 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](https://www.ftc.gov/sites/default/files/documents/public_statements/prepared-statement-federal-trade-commission-rent-own-transactions/110726renttoowntestimony.pdf).

consumer protection issues in the rent-to-own industry.<sup>98</sup> The Bureau ultimately decided to push forward with investigating these entities in 2017 and issued a CID to a rent-to-own 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.<sup>99</sup> 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.<sup>100</sup> 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.<sup>101</sup> 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.<sup>102</sup>

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

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<sup>98</sup> 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>.

<sup>99</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_petition-to-modify_rent-a-center-inc_decision-and-order.pdf).

<sup>100</sup> See Order on Defendant's Motion to Dismiss, *Consumer Financial Protection Bureau v. ITT Educational Services, Inc.*, 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](https://www.govinfo.gov/content/pkg/USCOURTS-insd-1_14-cv-00292/pdf/USCOURTS-insd-1_14-cv-00292-0.pdf).

<sup>101</sup> 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>.

<sup>102</sup> 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/>.

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-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.<sup>103</sup> 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.<sup>104</sup>

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.<sup>105</sup> 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.<sup>106</sup> Both companies received a 30-40 percent cut of the gross revenue from these third-party charges to customers.<sup>107</sup>

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.<sup>108</sup> In a public statement,

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<sup>103</sup> See *Consumer Fin. Prot. Bureau v. Accrediting Council for Indep. Colleges & Sch.*, 854 F.3d 683, 692 (D.C. Cir. 2017).

<sup>104</sup> 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>.

<sup>105</sup> 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](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. N.J. May 12, 2015), available at [https://files.consumerfinance.gov/f/201505\\_cfpb-cfpb-v-verizon-complaint.pdf](https://files.consumerfinance.gov/f/201505_cfpb-cfpb-v-verizon-complaint.pdf).

<sup>106</sup> See Sprint Complaint, at 20, 24-25.

<sup>107</sup> 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/>.

<sup>108</sup> See Sprint Complaint, at 9; Verizon Complaint, at 10.

Sprint lamented the Bureau’s decision to use the matter as a “test case” to determine its authority over wireless carriers.<sup>109</sup> Sprint and Verizon settled the action with the Bureau by agreeing to pay \$120 million in consumer refunds and additional \$38 million in fines.<sup>110</sup>

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.<sup>111</sup> 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.

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<sup>109</sup> See <https://www.marketwatch.com/story/cfpb-testing-its-reach-in-lawsuit-against-sprint-billing-practices-2014-12-19>.

<sup>110</sup> 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/>.

<sup>111</sup> 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.<sup>112</sup> Congress created the Federal Reserve System to foster a financial system that was safer, adaptable, and more stable.<sup>113</sup> 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,”<sup>114</sup> certain nonbank financial companies, and certain insurance holding companies.<sup>115</sup> 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,<sup>116</sup> and U.S. federal branches of foreign banks.<sup>117</sup> The OCC provides consumer protection and safety and soundness oversight for these entities through its rulemaking, supervisory, and enforcement powers.<sup>118</sup> Its enforcement powers include the ability to revoke national charters and issue cease and desist orders.<sup>119</sup>

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<sup>112</sup> See <https://www.federalreserve.gov/aboutthefed/structure-federal-reserve-system.htm>.

<sup>113</sup> 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](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).

<sup>114</sup> For example, financial market utilities participating in payment clearance and settlement.

<sup>115</sup> See [https://www.federalreserve.gov/aboutthefed/files/pf\\_5.pdf](https://www.federalreserve.gov/aboutthefed/files/pf_5.pdf).

<sup>116</sup> See <https://www.occ.treas.gov/about/what-we-do/index-what-we-do.html>.

<sup>117</sup> 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>.

<sup>118</sup> See <https://www.occ.treas.gov/about/what-we-do/index-what-we-do.html>.

<sup>119</sup> 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.<sup>120</sup> The FDIC may also exercise regulatory authority over almost all federally insured institutions by issuing rules and examining institutions for potential risks.<sup>121</sup> The Dodd-Frank Act also gave the FDIC authority to remedy issues with failing or troubled covered financial companies, brokers and dealers.<sup>122</sup> 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.<sup>123</sup>

### 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

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<sup>120</sup> See 12 U.S.C. 1820(b); see also CRS Report R44918, *supra* note 117, at 14.

<sup>121</sup> See <https://www.fdic.gov/about/strategic-plans/strategic/supervision.html>.

<sup>122</sup> See CRS Report R44918, *supra* note 117, at 14.

<sup>123</sup> See Joint Memorandum of Understanding on Supervisory Coordination (2012), available at [https://files.consumerfinance.gov/f/201206\\_CFPB\\_MOU\\_Supervisory\\_Coordination.pdf](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.<sup>124</sup>

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.<sup>125</sup> 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.<sup>126</sup> 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.<sup>127</sup>

## 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.<sup>128</sup> 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.<sup>129</sup> 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.<sup>130</sup> Although other regulators do not have the authority to veto

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<sup>124</sup> See <https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority>.

<sup>125</sup> See Section 1061(b)(5) of the Dodd-Frank Act; Section 5 of the FTC Act.

<sup>126</sup> 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.

<sup>127</sup> See <https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority>.

<sup>128</sup> See Section 1026(d)(1) of the Dodd-Frank Act.

<sup>129</sup> See e.g., *id.* at Section 1015.

<sup>130</sup> 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.<sup>131</sup>

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.<sup>132</sup> 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.<sup>133</sup> With respect to nondepositories, the Bureau is required to coordinate its supervisory activities with the prudential regulators and relevant state agencies.<sup>134</sup>

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.<sup>135</sup> 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.<sup>136</sup>

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 and an external party, i.e., generally, a federal or state agency or an organization with a shared

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<sup>131</sup> See *id.* at Section 1023(a).

<sup>132</sup> See *id.* at Section 1025(e)(1). See also *id.* at Section 1024(b)(3).

<sup>133</sup> See *id.* at Section 1025(a)(3).

<sup>134</sup> See *id.* at Section 1024(b)(3).

<sup>135</sup> 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).

<sup>136</sup> See Interagency Guidance regarding Unfair or Deceptive Credit Practices, *supra* note 135, at note 157.

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 CFPB 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.<sup>137</sup> 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.<sup>138</sup>

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.<sup>139</sup> 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 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.

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<sup>137</sup> See Memorandum of Understanding between the Consumer Financial Protection Bureau and the Federal Trade Commission (2019).

<sup>138</sup> See *id.*

<sup>139</sup> 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>.

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.<sup>140</sup> 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.<sup>141</sup> 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 laws intended to have a national impact. Naturally, federal preemption, which is essentially the

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<sup>140</sup> See Christine Daleiden, *Financial Reform for Consumers: An Overview of the Dodd-Frank Act and the Consumer Protection Bureau*, HAW. B.J. (April 2011).

<sup>141</sup> See Congressional Research Service, *Federal Preemption in the Dual Banking System: An Overview and Issues for the 116<sup>th</sup> Congress*, R45726 (2019).

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.”<sup>142</sup> 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 “factional 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 to guard [the people] against those violent and oppressive factions, which imbitter the blessings

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<sup>142</sup> *Federalist* No. 51.

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.<sup>143</sup> 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.<sup>144</sup> 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.<sup>145</sup> 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.<sup>146</sup>

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

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<sup>143</sup> Federalist No. 11.

<sup>144</sup> 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”).

<sup>145</sup> See Michael S. Greve, *The Upside-Down Constitution* 19-22 (2012).

<sup>146</sup> 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-deposit/](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-deposit/).

regulated industries.”<sup>147</sup> 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.<sup>148</sup> State regulators stand to lose both power and billions of dollars in licensing fees.<sup>149</sup> 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.<sup>150</sup>

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.”<sup>151</sup> 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,” and therefore, did not include activities like those of nondepository FinTechs.<sup>152</sup> However, the ruling did not end the FinTech quest for chartering. The OCC issued its first full-service charter,

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<sup>147</sup> Jeremy Kidd, *Fintech: Antidote to Rent-Seeking?*, 93 Chicago-Kent L. Rev. 165, 165 (2018).

<sup>148</sup> 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>.

<sup>149</sup> 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>.

<sup>150</sup> See *id.*

<sup>151</sup> See 12 U.S.C. 27; See Maria T. Vullo, *supra* note 146.

<sup>152</sup> 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).



rather than its controversial FinTech charter, to the first FinTech in 2020.<sup>153</sup> The charter was issued to Varo Bank, N.A., a full-service digital bank that offers checking and savings accounts through its mobile application.<sup>154</sup> Additionally, the Acting Comptroller announced that the OCC plans to introduce a payments charter that would preempt state payments licensing requirements.<sup>155</sup>

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.<sup>156</sup>

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.<sup>157</sup> 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

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<sup>153</sup> See <https://www.occ.treas.gov/news-issuances/news-releases/2020/nr-occ-2020-99.html>.

<sup>154</sup> See <https://www.bloomberg.com/news/articles/2020-07-31/varo-becomes-first-consumer-fintech-to-land-a-national-charter>.

<sup>155</sup> 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>.

<sup>156</sup> 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).

<sup>157</sup> See *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

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.<sup>158</sup> 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"<sup>159</sup> 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 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

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<sup>158</sup> See discussion in chapter 10; see also NCCF Report, *supra* note 2, at 207.

<sup>159</sup> See <https://corplaw.delaware.gov/why-businesses-choose-delaware/>.

Innovation Network” (ACFIN) provides a model for an additional way forward.<sup>160</sup> 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.<sup>161</sup> 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.<sup>162</sup> Jurisdictional competition has allowed regulators to learn from their own successes and failures and those of other regulators. In the financial sector, jurisdictional 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.<sup>163</sup>

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

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<sup>160</sup> 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/>.

<sup>161</sup> NCCF Report, *supra* note 2.

<sup>162</sup> See G. Marcus Cole commentary, available at <https://www.consumerfinance.gov/about-us/events/archive-past-events/taskforce-public-hearing/>.

<sup>163</sup> See *id.*

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 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.<sup>164</sup> The Dodd-Frank Act embraces a conflict preemption standard.<sup>165</sup> 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.<sup>166</sup> Under the Dodd-Frank Act, a state law is not preempted unless it is "inconsistent" or in conflict with the Act.<sup>167</sup> The law specifies that a state affording consumers more protection than the Dodd-Frank Act confers does not constitute a conflict.<sup>168</sup>

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.

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<sup>164</sup> See *Baptista v. JPMorgan Chase Bank, N.A.*, 640 F.3d 1194 at 1197(2011).

<sup>165</sup> See Section 1041(a)(1) of the Dodd-Frank Act.

<sup>166</sup> See Dori K. Bailey, *Preemption Principles: Weighing the Impact of Dodd-Frank*, Banking & Fin. Services Pol'y Rep. at 2 (July 2015).

<sup>167</sup> See Section 1041(a)(2) of the Dodd-Frank Act.

<sup>168</sup> See *id.*

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.<sup>169</sup>

The Dodd-Frank Act's second preemption scenario codifies the Court's ruling in *Barnett Bank of Marion County, N.A. v. Nelson*.<sup>170</sup> 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.<sup>171</sup> 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.<sup>172</sup> 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.<sup>173</sup> *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.<sup>174</sup> 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..<sup>175</sup>

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.<sup>176</sup> 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

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<sup>169</sup> See Dori K. Bailey, *supra* note 166.

<sup>170</sup> See Section 1044 of the Dodd-Frank Act.

<sup>171</sup> See *Barnett Bank of Marion Cnty., N.A. v. Nelson*, 517 U.S. 25 (1996).

<sup>172</sup> See Dori K. Bailey, *supra* note 166.

<sup>173</sup> See *Baptista*, 640 F.3d 1194.

<sup>174</sup> See Dori K. Bailey, *supra* note 166.

<sup>175</sup> See Section 1044 of the Dodd-Frank Act.

<sup>176</sup> See *Watters v. Wachoiva Bank, N.A.*, 551 U.S. 1 (2007).

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).<sup>177</sup> 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.<sup>178</sup>

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.<sup>179</sup>

Additionally, the law authorizes states to enforce rules promulgated pursuant to the CFPA against a national bank or federal savings association.<sup>180</sup> But states may not enforce the CFPA, itself, against national banks.<sup>181</sup>

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.

## 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.

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<sup>177</sup> See Section 1044(e) of the Dodd-Frank Act.

<sup>178</sup> 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.

<sup>179</sup> See *id.* at Section 1042(a)(1).

<sup>180</sup> See *id.* at Section 1042(a).

<sup>181</sup> See *id.* at Section 1042(a)(2).

## 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,"<sup>182</sup> 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.<sup>183</sup> On the other hand, others argue that some of these criticisms may be unfounded and are outweighed by the benefits to consumers. Some have argued that in the field of corporate law, competition among the states pushes toward optimal laws.<sup>184</sup> 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.

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.

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<sup>182</sup>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.")

<sup>183</sup> 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), available at [www.jstor.org/stable/4508425](http://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=yli>

<sup>184</sup> Roberta Romoano, *The Genius of American Corporate Law*, American Enterprise Institute (1993), available at <https://EconPapers.repec.org/RePEc:aei:rpbook:53342>.



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.<sup>185</sup> 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.<sup>186</sup> 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.<sup>187</sup> 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 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

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<sup>185</sup> See Joint Statement, available at <https://www.ncua.gov/newsroom/press-release/2020/agencies-encourage-financial-institutions-meet-financial-needs-customers-and-members-affected>.

<sup>186</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_interagency-statement_real-estate-transactions-covid-19.pdf).

<sup>187</sup> 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>.

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.<sup>188</sup> Consumer demand for used cars has dramatically increased along with the cost of procuring one since the global pandemic due to reduced auto production and concerns about close-quarters on public transportation.<sup>189</sup> 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.<sup>190</sup> So, auto dealers' profits are directly linked to the cost to consumers. In some instances, regulators have alleged and studies have concluded 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.<sup>191</sup> In perhaps one of the most flagrant

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<sup>188</sup> See Congressional Research Service, *The Automobile Lending Market and Policy Issues*, IF11192 (April 2019), available at <https://fas.org/sgp/crs/misc/IF11192.pdf>.

<sup>189</sup> See e.g. <https://www.npr.org/2020/10/28/927971920/a-pandemic-sticker-shock-used-car-prices-are-through-the-roof>.

<sup>190</sup> See CRS Report IF11192, *supra* note 188.

<sup>191</sup> 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\\_o.pdf](https://www.ftc.gov/system/files/documents/cases/bronx_honda_complaint_o.pdf); Bureau Press Release

instances of discrimination, a dealership in the New York's Bronx borough allegedly instructed its employees to charge higher prices to these consumers specifically.<sup>192</sup> 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.<sup>193</sup>

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 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

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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>.

<sup>192</sup> See Complaint at 26, *Federal Trade Commission v. Liberty Chevrolet Inc., et al.*, (S.D.N.Y. 2020) (No. 20-CV-3945).

<sup>193</sup> 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](https://www.ftc.gov/system/files/documents/public_statements/1576006/bronx_honda_2020-5-27_bx_honda_rks_concurrence_for_publication.pdf).

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.<sup>194</sup> 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.<sup>195</sup> Franklin says that 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 ..."<sup>196</sup>

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

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<sup>194</sup> 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>.

<sup>195</sup> Boardman, A. E., Greenberg, D. H., Vining, A. R., & Weimer, D. L. Cost-Benefit Analysis; Concepts and Practice (2018).

<sup>196</sup> Letter from Benjamin Franklin to Joseph Priestly (1772) in Boardman et. al, *supra* note 195.

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.<sup>197</sup>

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.<sup>198</sup> 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.<sup>199</sup> This reform substantially reduced the number of rules that OMB reviewed.<sup>200</sup> 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 ranging from valuing reductions in mortality risks to the discount rates agencies should use for future benefits and costs to reflect social time preference.<sup>201</sup> 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.<sup>202</sup> President Trump's EO

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<sup>197</sup> 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>

<sup>198</sup> Stuart Shapiro, *The Evolution of Cost-Benefit Analysis in US Regulatory Decision-making* (2011), available at [https://pdfs.semanticscholar.org/do6b/2183437547e4b32614e798025713c169e685.pdf?\\_\\_ga=2.267257870.1026816008.1596222479-1635246547.1596222479](https://pdfs.semanticscholar.org/do6b/2183437547e4b32614e798025713c169e685.pdf?__ga=2.267257870.1026816008.1596222479-1635246547.1596222479)

<sup>199</sup> Exec. Order No. 12,866 (1993), available at <https://www.archives.gov/files/federal-register/executive-orders/pdf/12866.pdf>.

<sup>200</sup> Data from [www.reginfo.gov](http://www.reginfo.gov), comparing the period Feb. 19, 1981 through Sept. 30 1993, with the period Oct. 1, 1993 through Sept. 30, 2017.

<sup>201</sup> 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>.

<sup>202</sup> 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>

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.<sup>203</sup>

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)).<sup>204</sup>

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.

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

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<sup>203</sup> Exec. Order No. 13,771 (2017), available at <https://www.govinfo.gov/content/pkg/FR-2017-02-03/pdf/2017-02451.pdf>

<sup>204</sup> 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>.



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.<sup>205</sup> In some ways, the establishment of principles and best practices is itself a best practice.

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<sup>205</sup> 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>



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.”<sup>206</sup> Third, we reviewed the United Kingdom’s Regulatory Policy Committee (RPC) guidance on regulatory impact assessments.<sup>207</sup> Fourth, we reviewed the best practices for CBA identified in the ACUS Recommendation 2013-2, *Benefit-Cost Analysis at Independent Regulatory Agencies*.<sup>208</sup> Fifth, we studied the Organisation of Economic Cooperation and Development’s (OECD) 2012 *Recommendation of the Council of Regulatory Policy and Governance*.<sup>209</sup> Lastly, the Taskforce consulted *Cost Benefit Analysis; Concepts and Practice* by Boardman et al.<sup>210</sup>

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:

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<sup>206</sup> 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>

<sup>207</sup> 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>

<sup>208</sup> 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>

<sup>209</sup> 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](https://read.oecd-ilibrary.org/governance/recommendation-of-the-council-on-regulatory-policy-and-governance_9789264209022-en#page1)

<sup>210</sup> Boardman, A. E., Greenberg, D. H., Vining, A. R., & Weimer, D. L. *Cost-Benefit Analysis; Concepts and Practice* (2018).

**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.<sup>211</sup> 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.

**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

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<sup>211</sup> Chapter 6 of this report provides an example highlighting the importance of proper baselining, where debt-collection protections implemented in 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.

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.<sup>212</sup> 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 to the 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.<sup>213</sup>

**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 should not be allowed to influence the estimated net benefits.<sup>214</sup> 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.

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<sup>212</sup> OMB Circular A-4 has an extended discussion of the various approaches to valuing benefits.

<sup>213</sup> *Id.*

<sup>214</sup> 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.

**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 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.<sup>215</sup> 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.<sup>216</sup> 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, but useful and detailed information about them can be found in OMB Circular A-4, Boardman et al., and Hanley et al.<sup>217</sup> 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.<sup>218</sup> 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

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<sup>215</sup> Stephen Hall, *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](https://files.consumerfinance.gov/f/documents/cfpb_hall_written-statement_symposium-cost-benefit-analysis.pdf)

<sup>216</sup> 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.

<sup>217</sup> Hanley, N., Shogren, J.F, White, B. *Environmental Economics in Theory and Practice*, 2<sup>ND</sup> ED., (2007).

<sup>218</sup> 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>

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.<sup>219</sup>

To some, the difficulty 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.<sup>220</sup> 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.<sup>221</sup> 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 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.<sup>222</sup>

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

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<sup>219</sup> *Id.*

<sup>220</sup> 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.

<sup>221</sup> Mark Cohen, *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](https://files.consumerfinance.gov/f/documents/cfpb_cohen_written-statement_symposium-cost-benefit-analysis.pdf)

<sup>222</sup> *Id.*

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.<sup>223</sup>

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.

## 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,

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<sup>223</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3659474)

and thereby foster regulatory quality.”<sup>224</sup> 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.<sup>225</sup>

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.<sup>226</sup> 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.<sup>227</sup> 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 regulations.<sup>228</sup> 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.<sup>229</sup> 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

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<sup>224</sup> 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](https://read.oecd-ilibrary.org/governance/recommendation-of-the-council-on-regulatory-policy-and-governance_9789264209022-en#page1)

<sup>225</sup> 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>.

<sup>226</sup> 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) .

<sup>227</sup> 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>.

<sup>228</sup> SUNSTEIN (2013), *supra* note 226 Chapter 1, pages 30-31.

<sup>229</sup> OIRA return letters are catalogued at <https://www.reginfo.gov/public/do/eoReturnLetters>



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.<sup>230</sup>

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.<sup>231</sup>

## 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 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

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<sup>230</sup> 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](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/252697/assessingregulationrpcnov2012report.pdf)

<sup>231</sup> 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](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3659474)

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.<sup>232</sup> The Taskforce reviewed for consistency with CBA principles and best practices, as well as Section 1022 of the Dodd-Frank Act.

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

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<sup>232</sup> 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 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).

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.

## 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.<sup>233</sup> 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

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<sup>233</sup> Payday, Vehicle Title, and Certain High-Cost Vehicle Installment Loans (3170-AA40; 82 FR 54472).

analyses and found no or very weak evidence to support market failure claims in three analyses.<sup>234</sup>

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.<sup>235</sup> 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 problem than any market failure claim.<sup>236</sup> 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.<sup>237</sup> 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

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<sup>234</sup> 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)

<sup>235</sup> 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](https://files.consumerfinance.gov/f/documents/cfpb_jackson_written-statement_symposium-cost-benefit-analysis.pdf).

<sup>236</sup> 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.

<sup>237</sup> 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.

monetization owes to insufficient data, information, or literature – but there are other instances when greater quantification and monetization were possible.<sup>238</sup>

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.<sup>239</sup> 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 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.<sup>240</sup> 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.<sup>241</sup>

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,

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<sup>238</sup> 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/cityscape/vol13num2/Cityscape\\_july2011\\_impact.pdf](https://www.huduser.gov/portal/periodicals/cityscape/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.

<sup>239</sup> 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.

<sup>240</sup> This statement applies to all rules reviewed by the task force.

<sup>241</sup> 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)

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.<sup>242</sup> 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.<sup>243</sup> 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 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.<sup>244</sup> 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.

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<sup>242</sup> 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)

<sup>243</sup> For instance, the 2017 Payday Lending Rule's maximum loan limit of \$500 seems to have been chosen without quantitatively analyzing alternative levels.

<sup>244</sup> 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.

### 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.<sup>245</sup>

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

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<sup>245</sup> Loan Originator Compensation Requirements Under the Truth in Lending Act (RIN: 3170-AA13; 78 FR 11279)



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.<sup>246</sup>

### 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 of the Dodd-Frank Act’s requirement to consider access to financial products could be more transparent.

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<sup>246</sup> 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).

## CHAPTER 13, APPENDIX A:

# Federal Financial Regulators and Who They Supervise<sup>247</sup>

**Table 1. Federal Financial Regulators and Who They Supervise**

Regulatory Agency	Institutions Regulated	Other Notable Authority
<b><i>Depository Regulators</i></b>		
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 FSO	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

<sup>247</sup> 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  Nationally recognized statistical rating organizations  Security-based swap (SBS) dealers, major SBS participants, and SBS execution facilities  Securities sold to the public	Approves rulemakings by self-regulated organizations
Commodity Futures Trading Commission (CFTC)	Futures exchanges, futures commission merchants, commodity pool operators, commodity trading advisors, derivatives clearing organizations, and designated contract markets  Swap dealers, major swap participants, swap execution facilities, and swap data repositories	Approves rulemakings by self-regulated organizations

### ***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***

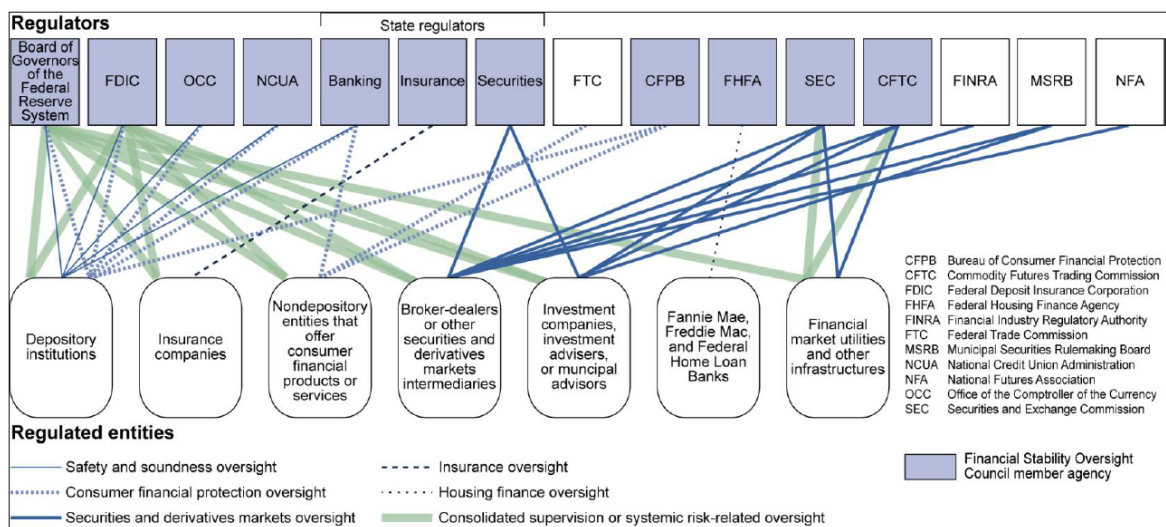
Consumer Financial Protection Bureau (CFPB)	Nonbank mortgage-related firms, private student lenders, payday lenders, and larger “consumer financial entities” determined by the CFPB  Statutory exemptions for certain markets  Rulemaking authority for consumer protection for all banks; supervisory authority for banks with over \$10 billion in assets	
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## CHAPTER 13, APPENDIX B:

# Regulatory Jurisdiction by Agency and Type of Regulation<sup>248</sup>

Figure 1. Regulatory Jurisdiction by Agency and Type of Regulation



Source: Government Accountability Office (GAO), *Financial Regulation*, GAO-16-175, February 2016, Figure 2.

<sup>248</sup> Congressional Research Service, *Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework* title, R44918 (2020).