

THE EFFECT OF THE CONSUMER FINANCIAL PROTECTION AGENCY ACT OF 2009 ON CONSUMER CREDIT

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I. Introduction

In 2009, the United States Department of the Treasury submitted the Consumer Financial Protection Agency (CFPA) Act of 2009 to Congress, proposing a sweeping overhaul of consumer financial regulation.¹ Congress has wrestled with the Administration's proposal in the ensuing months. In December 2009, the House of Representatives passed a bill that adopted some key elements of the Administration's bill but discarded others.² As of the printing of this Article, the Senate is still

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¹ UNITED STATES DEPARTMENT OF THE TREASURY, CONSUMER FINANCIAL PROTECTION AGENCY ACT OF 2009 (2009), *available at* <http://www.financialstability.gov/docs/CFPA-Act.pdf> (last visited Feb. 10, 2010) [hereinafter CFPA Act] (proposing 2009 Consumer Financial Protection Agency legislation for passage by Congress). The reforms of consumer financial protection and the proposal to create a single agency were presented on July 17, 2009 in UNITED STATES DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 55-75 (2009) [hereinafter New Foundation], *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (last visited Feb. 10, 2010) (outlining proposals for various governmental regulations of financial services and credit products).

² We discuss the differences between the Administration and the House bill below. *See generally, infra* note 13 and accompanying text.

working on this contentious subject, and, as of the end of 2009, no bill had advanced to a Committee vote. This Article analyzes the Administration's bill since it provides the template for the other legislation considered and because some of the ideas advanced by the Treasury Department are worthy of debate regardless of whether they are adopted during the current session of Congress (or at all).

The Administration's proposed legislation would create a new agency that would assume many of the consumer protection functions of several federal regulatory agencies, and have jurisdiction over virtually all consumer financial products and services.³ The new agency is intended to achieve stronger regulation of consumer financial products and services through more extensive powers than existing agencies have under current laws.⁴ Under the Administration's bill, the CFPA would have the power to, among other things:

- Prohibit certain consumer financial products or services or features of those products or services;⁵
- Impose more stringent and intrusive disclosure requirements on providers of consumer financial products and services;⁶
- Require that providers offer "plain vanilla" products that the agency would design, before or at the same time those providers offered their own variants on these standard products;⁷ and
- Ensure that underserved consumers and communities would have access to consumer

³ These include the Federal Reserve Board of Governors, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, National Credit Union Administration, and the Federal Trade Commission. *See* CFPA Act, *supra* note 1, at § 1061(a). While the CFPA would normally regulate many consumer financial products and services, there are two principal exceptions: (1) insurance would be excluded, except for credit insurance, mortgage insurance, and title insurance; and (2) investment products that are already regulated by the SEC or CFTC would be excluded. CFPA Act, *supra* note 1, at § 1082(d).

⁴ New Foundation, *supra* note 1, at 3 ("We propose . . . stronger regulations to improve the transparency, fairness, and appropriateness of consumer and investor products and services").

⁵ CFPA Act, *supra* note 1, at § 1031(c).

⁶ *Id.* at § 1032.

⁷ *Id.* at § 1036(b).

services, lending, and investment.⁸

The proposed legislation expressly allows states and localities to impose stricter regulations than those adopted by the CFPB and engage in enforcement efforts complementing those conducted by the CFPB.⁹ The Act would therefore end federal preemption of state consumer protection for nationally chartered financial institutions. The Act would also change the law on consumer financial protection by extending the current condemnation of “unfair and deceptive practices” to include “abusive” practices,¹⁰ and require that lenders make “reasonable” disclosures.¹¹

The Treasury Department initially proposed this new system of consumer financial protection in its June 2009 white paper *Financial Regulatory Reform: A New Foundation*. However, the proposal for the new agency and many of the key principles for how this agency would regulate consumer financial products were presented in articles and reports that were authored by several law professors, including the Assistant Secretary of the Treasury who was significantly involved in the drafting of the legislation.¹² These articles and reports provide the intellectual foundation for modifications in consumer protection regulation, premised on the assumption that consumers are irrational and make mistakes systemically in how they borrow money. Accordingly, these writings provide a guide for how its proponents intend the new agency and laws to work.

This Article concludes that CFPB Act as proposed by the

⁸ *Id.* at § 1014(c)(2).

⁹ *Id.* at § 1035(a). Currently, OCC rules preempt states and localities from supervising, examining and regulating the business activities of national banks and their operating subsidiaries. 12 C.F.R. pt. 7, 34; UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS (2006), available at <http://www.gao.gov/new.items/d06387.pdf> (last visited Feb. 10, 2009). See also Home Owners' Loan Act of 1933, 12 U.S.C. §§ 1461-1470 (2006).

¹⁰ The terms “abusive” and “abuse” are not defined in the Act. See generally CFPB Act, *supra* note 1, at § 1002 (listing definitions of various terms under the proposed Act).

¹¹ CFPB Act, *supra* note 1, at § 1032(b).

¹² See, e.g., Michael S. Barr, Sendhil Mullainathan & Eldar Shafir, *Behaviorally Informed Financial Services Regulation* 1 (New American Foundation Working Paper, October 2008); Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 39 (2008).

U.S. Department of the Treasury would:

- Make it harder and more expensive for consumers to borrow, and would risk reversing the decades-long trend towards the democratization of credit;
- Create a “supernanny” agency that is designed to substitute the choice of bureaucrats for those of consumers; and
- Jeopardize financial recovery by reducing credit during a severe economic recession; a time when the economy is fragile and there is already too little credit.

We briefly explain each of our findings in this introduction.

The Treasury’s CFPA Act would also make it harder and more expensive for consumers to borrow. It would likely:

- Prohibit lenders from offering some credit products and services that benefit consumers. The CFPA would have the power to prohibit such products and services. Meanwhile, proponents of the agency have argued that many common products, including subprime mortgages and credit cards, are of little benefit to consumers.
- Impose significant additional costs on lenders that would be passed on to borrowers. These costs would include exponentially higher litigation and regulatory costs that would result from allowing states and municipalities to adopt more stringent regulations, and simultaneously imposing new and untested liability standards on lenders. They also include the costs of complying with the stronger regulations that the CFPA is likely to apply.
- Require lenders to push consumers towards lending products designed by the CFPA. The CFPA would have the power to impose significant costs on lenders offering innovative lending products *and* the consumers who want them. The CFPA’s proponents strongly advocated this paternalistic approach in which the government provides “nudges” to force consumers to take an option these proponents prefer. There is no reason

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to believe that products designed by a regulatory agency would be better than those designed by lenders and freely chosen by consumers. (The CFPA may have sufficient powers to “induce” lenders to provide products of its design even without the ability to require lenders to offer “plain vanilla” products.)

These aspects of the CFPA Act would result in consumers losing access to methods of lending that the agency prohibits, or, in other cases, forcing lenders to withdraw as a result of the higher costs they incur. Lenders will also pass on the higher costs resulting from federal and state regulation of lending products to consumers in the form of higher interest rates and fees. These aspects of the CFPA Act would likely reverse the decade long trend towards the democratization of credit. The increased cost of lending coupled with requirements to offer agency-designed products is likely to result in a significant reduction in credit availability, particularly to people who have historically had more difficulty obtaining access to credit. Finally, the increased cost of credit and reduced availability would impose collateral damage on small businesses that often rely on consumer financial products.

The CFPA Act would create a “supernanny” that is designed to substitute bureaucratic choice for consumer choice. The CFPA Act, as explained by its proponents, is based on the findings of “behavioral law and economics” that consumers make bad decisions when it comes to financial services products and would be made better off with the government steering them to better decisions. A Consumer Financial Protection Agency premised on this paternalistic view would be prone to replace what consumers believe is in their interest with its own views. It is doubtful that even the most well-educated bureaucrats could design sustainable and profitable products better suited to satisfy consumer needs than those designed by lenders. Similarly, it is unlikely that any group of regulators could make better decisions to police borrowing terms than the consumers with the greatest stake in the loan.

The CFPA Act poses especially severe risks to American households and to the economy over the next few years. The American economy remains fragile. Credit availability to households remains restricted, which has hurt those households directly. The credit crunch has also indirectly harmed consumers

through decreased economic activity, resulting in fewer jobs and reduced incomes. In addition to the long-run effects the CFPA Act would have on credit availability, the proposed legislation would also especially dampen credit availability in the near-term because financial institutions would face a great deal of uncertainty over the scope and risks of the new regulations. The resulting reduction in credit availability would likely slow the nascent economic recovery and especially impact job creation as a result of the multiplier effect of consumer spending on economic activity. It would also dampen the formation of new businesses that generate most of the economy's net new jobs. Adopting a new regulatory system for consumer financial products that would make it more difficult for consumers to borrow in 2010 and 2011 is an especially bad idea.

Our conclusion is that the Treasury Department's CFPA Act of 2009 is a misguided attempt to erect an agency that could substitute its own view for those of consumers on how and under what circumstances consumers should be able to borrow money. Short-term, the CFPA Act would tighten the credit crunch that still threatens the economy; long-term, it would reduce the availability of credit to both consumers and small businesses. Most alarmingly, the CFPA Act-induced reduction in credit availability would reverse successful efforts to democratize credit by which all segments of American consumers have increasingly been able to borrow to meet their short-term and long-term needs.¹³

The remainder of the Article explains the basis for our conclusions. One must begin with an understanding as to how consumers benefit from the variety of lending products available to them in order to understand why the CFPA Act will likely

¹³ On December 11, 2009, the U.S. House of Representatives passed the *Wall Street Reform and Consumer Financial Protection Act of 2009*. H.R. 4173, 111st Cong. (2009). Title IV of that bill addresses consumer financial protection. See generally CFPA Act, *supra* note 1, at § 4001. There are many key differences between the House bill and the Administration's proposed bill. Most importantly the House bill eliminates the proposed "plain vanilla" provisions discussed at some length in this paper as well as the proposed "reasonableness" requirements. The House bill also retains elements of the "state preemption" problems we discuss, though it limits these with regards to banks at the discretion of the Office of the Comptroller of the Currency. The House bill nevertheless still imposes liability for "abusive" lending practices, consolidates vast swaths of financial regulation in the Director of the Agency, and provides states various incentives to litigate, such as the opportunity to recover litigation costs. *Id.* at §§ 4301(a), 4102(a)(2), 4505(b).

prove harmful. Furthermore, it is important to recognize how financial innovation through the proliferation of consumer credit products has democratized credit by making it available to an ever-broadening segment of society. Accordingly, we explain each of these in Sections II and III respectively. We then turn in Section IV to explaining the rationale for the CFPA Act as proposed. In Section V, we analyze how the provisions of the CFPA Act and the powers granted to the new agency would likely affect the cost and availability of consumer credit to households and small businesses. Finally, Section VI presents our conclusion – the CFPA Act would likely harm consumers and small businesses by restricting the availability of credit at a time when the economy needs more, rather than less, credit.

II. Consumer Borrowing

A. Consumer Benefits from Borrowing

Households mainly borrow to even out how much they consume over their lifecycles. People tend to have increasing wages over the first couple of decades of their time in the workforce. Wages eventually plateau and then decline until retirement. Table 1 shows that this trend varies according to educational level. If people neither borrowed nor saved, they would live much better in middle age than earlier or later stages of their earnings cycle. In fact, to the extent they are able to, households usually borrow more when they are young. They may take out substantial loans to finance education, purchase durable consumer goods, or even purchase a home. As individuals get older, however, they can reduce borrowing and become “net savers” through home ownership or other investments. They draw down their investments, plus forced savings such as social security, after they leave the work force. Table 2 shows the typical profile of borrowing and asset accumulation over a lifecycle.

Table 1. Lifetime earnings for different levels of education in 2007 dollars.

Education Level	18-24	25-34	35-44	45-54	55-64	65+
< High school	10,890	21,676	24,385	25,800	24,841	24,691
High school	16,791	28,982	36,060	36,562	34,160	25,679
Some college	13,477	31,843	41,541	44,201	40,838	31,938
Bachelor's degree	25,976	51,580	71,394	76,993	72,368	55,517
Postgraduate		60,336	86,603	92,471	86,080	59,944

Note: Earnings values correspond to averages for male and female workers.

Source: U.S. Bureau of the Census, Historical Income Tables, available at <http://www.census.gov/hhes/www/income/histinc/p28.html>.

Table 2. Borrowing and income over the lifecycle in 2007 dollars.

Age	Income	Debt
< 35	\$51,700	\$100,700
35 - 44	\$83,700	\$148,000
45 - 54	\$112,400	\$148,500
55 - 64	\$111,200	\$131,500
65 - 74	\$92,400	\$107,700
> 74	\$45,700	\$45,100

Note: Debt includes consumer and mortgage debt. Income corresponds to average annual before-tax income.

Source: Federal Reserve Board of Governors, Survey of Consumer Finance, 2007. The debt line shows the level of accumulated debt at a point in time while the income line shows the annual income at a point in time.

Consumers borrow for other reasons as well. Some consumers borrow because they have experienced unanticipated drops in income, perhaps due to a job loss or a divorce. Others borrow because they have an unusual expense, such as a wedding or a vacation. Many consumers also borrow to pay for more frequent or necessary expenses such as buying clothes or groceries.¹⁴ As has always been the case, some consumers take on

¹⁴ Consumer surveys have found that consumers typically prefer to use their debit cards instead of credit cards for small everyday purchases. *See, e.g.,* Susan Reda, *2003 Consumer Credit Survey*, STORES MAGAZINE, Nov. 2003. Further, economists explain the underlying consumer preference to use debit

more debt than they should and run into trouble.¹⁵ But, by and large, most people borrow responsibly.¹⁶

Consumers benefit directly from borrowing. Economists have shown that as a result of aligning consumption and income more closely, consumers can increase their overall level of well-being over their lifetimes. In any event, most people who can borrow against their future incomes tend to enjoy a nicer lifestyle when they are younger than they could achieve from current income.¹⁷ Consumers also benefit indirectly from borrowing. By buying more, consumers enable businesses to expand production and create more jobs.¹⁸ This, in turn, raises consumer income and spending. Moreover, international experience also suggests that the availability of credit spurs economic growth.¹⁹

cards instead of credit cards with “mental accounting.” Mental accounting refers to the thought process that consumers engage in before they enter into a transaction that discourages them from overspending, and serves as a mechanism for self-regulation. See Drazen Prelec & George Loewenstein, *The Red and The Black: Mental Accounting of Savings and Debt*, 17 *MARKETING SCIENCE* 4 (1998).

¹⁵ See generally Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 *NW. U. L. REV.* 1463, 1492-99 (2005).

¹⁶ The American Bankruptcy Institute reported that there were 1,064,927 personal bankruptcy filings in 2008, which corresponds to less than 1% of U.S. households. See American Banking Institute, Press Release, *Consumer Bankruptcy Filings up Nearly 33 percent in 2008* (Jan. 9, 2009), available at <http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=56120> (last visited Feb. 10, 2010). According to the Mortgage Bankers Association, 3.3 percent of mortgages were in the foreclosure process at the end of 2008. See also, Mortgage Bankers Association, Press Release, *Delinquencies and Foreclosures Continue to Climb in Latest MBA National Delinquency Survey per American* (May 28, 2009), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/69031.htm> (last visited Feb. 10, 2010). The average credit card default was 5.73% in August according to Moody's. See *Moody's Credit Card Index Improves in July*, *FORBES*, Aug. 21, 2009. These rates are lower during normal economic times.

¹⁷ Economists explain this pattern of consumer behavior with the permanent income hypothesis according to which people base their consumption expenditures on long-term income trends. See Paul Samuelson & William Nordhaus, *ECONOMICS* 16, 421 (1998).

¹⁸ The essence of this is the multiplier mechanism where an increase in investment raises the income of consumers and thereby leads to a cascading chain of further spending increases. See *id.* at 446-54.

¹⁹ See Aghion Philippe, Abhijit V. Banerjee, George-Marios Angeletos & Kalina B. Manova, *Volatility and Growth: Credit Constraints and Productivity-Enhancing Investment*, MIT DEPARTMENT OF ECONOMICS WORKING PAPER NO. 05-15, Apr. 30, 2005, available at

B. The Risks of Lending to Consumers

Financial institutions, however, face some serious problems in lending to consumers. There is great uncertainty over the ability of any individual to pay back a loan. The earnings with which an individual borrower can pay back the loan are unknown and in the future. Moreover, it can be difficult to collect when people default because sometimes their only collateral is whatever money they might earn from future work. Lending faces the well-known problems of adverse selection (loans are most attractive to those who are least likely to pay them back); asymmetric information (borrowers know more about their ability to repay than lenders ever could); and moral hazard (borrowers will take less care to repay loans if they know they can avoid repayment as a result of debt relief laws, rules and programs, and possible lender forbearance).

The risks to lenders from adverse selection, asymmetric information, and moral hazard tend to result in precautionary limits on the amount of lending — or liquidity — available to consumers. Under extreme conditions, consumers who want to borrow cannot find anyone to lend to them. Centuries ago there was little consumer lending because of the risks of collecting; and there was little borrowing because laws to ensure repayment — and thus reduce moral hazard — had draconian consequences including time in “debtor prison”.²⁰

Economists use the term “liquidity constraint” to refer to the situation in which an individual cannot receive additional credit at any price. Some households cannot receive any credit at all while other households cannot receive additional credit even though they are willing to pay for it. Over the years, consumers have seen the relaxation of these liquidity constraints as a result of the development of financial markets and innovations in the provision of financial products and services that have enabled lenders to better deal with adverse selection, asymmetric

<http://ssrn.com/abstract=719772> (last visited Feb. 10, 2010) (finding that “tighter financial constraints make R&D investment and growth more sensitive to shocks, while also generating a more negative correlation between volatility and growth to both higher aggregate volatility” for a panel of countries over the period 1960-2000).

²⁰ Even English landowners did not mortgage their property before the 1600s because if they missed a payment, they forfeited their entire holdings. See generally Giuseppe Bertola et al., *THE ECONOMICS OF CONSUMER CREDIT* 1-27 (MIT Press 2006).

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information, and moral hazard problems. These developments have especially benefited members of socially and economically disadvantaged groups. Over the last several decades, the supply of credit has become democratized with, as we will discuss below, all but the very poorest members of society able to borrow to some degree.

C. Moral Objections to Borrowing and Lending

Not everyone has applauded the democratization of consumer borrowing over the years. There has been an almost constant thread of moral opprobrium to borrowing from various quarters since the early days of our country. During the 19th century, as retailers increasingly provided consumer credit, various social commentators warned against the practice. One social critic chastised women for the “curious process of reasoning” that led them to buy on installment rather than paying up front.²¹ By the turn of the 20th century, social commentators further warned against the evils of spending and going into debt through morality tales such as *Keeping Up with Lizzie* (which inspired the subsequent comic strip *Keeping up with the Joneses*). As Irving Bacheller’s “*Charge It*” observed in 1912, “Credit is the latest ally of the devil. It is the great tempter. It is responsible for half the extravagance of modern life.”²² These commentators have argued for public policies to prevent consumers from borrowing.²³

American consumers have largely chosen to ignore this well-meaning advice throughout the nation’s history. Instead, American consumers have embraced new forms of credit that enable them to enhance their current standards of living through borrowing. By and large that is an economically sensible response to the shape of lifecycle earnings, and most consumers do so responsibly. As we will see below, the academic scholars who designed the CFPA and are its leading proponents are the intellectual heirs of the social critics who thought that credit is the “great tempter” from which consumers should be restrained and protected.

²¹ Lendol Calder, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* 181 (Princeton University Press 2001).

²² Irving Bacheller, “CHARGE IT,” OR KEEPING UP WITH HARRY 116 (Harper & Brothers 1912).

²³ CALDER, *supra* note 21, at Ch.3.

III. The Democratization of Consumer Lending

Beginning in the early 1980s, a number of innovations significantly reduced liquidity constraints, thereby enabling more Americans to borrow more.²⁴ These innovations helped increase credit availability dramatically for members of socially and economically disadvantaged groups, and consequentially democratized credit. The gaps between credit availability for households headed by upper income white men and credit availability for households headed by single parents, the less well-off, and minorities closed considerably. The expansion in consumer spending also helped fuel economic growth and job creation and helped sustain a long period of economic expansion that began in 1982 and continued, with some minor recessions along the way, until the recent financial crisis.

A. Computerized Risk Analysis and Securitization

Innovations in computerized risk analysis and securitization were both major developments that triggered these improvements. Both innovations, however, have become controversial recently as each played a contributing role in the current financial crisis. After we describe these innovations, we will explain that it was the failure of financial institutions to properly use these tools rather than a problem with the tools themselves that led to the crisis. It is therefore important to preserve the benefits of these innovations while dealing directly with the problems that were exposed by the financial crisis.

i. Risk Analysis

We mentioned earlier that lenders are reluctant to provide credit to individuals because of problems of adverse selection, asymmetric information, and moral hazard. Advances in risk analysis over the last three decades have steadily reduced the severity of these problems. Those advances have resulted from a combination of the information technology revolution (which has provided more and cheaper computer power), the increased availability of credit-related data on individuals, and the development of sophisticated algorithms for predicting risk.²⁵

²⁴ Angela Lyons, *How Credit Access Has Changed Over Time for U.S. Households*, 37 THE J. OF CONSUMER AFFAIRS 231, 248 (2003).

²⁵ Robert M. Hunt, *A Century Of Consumer Credit Reporting in America*

Sophisticated “automatic underwriting” of loans began with credit cards; such loans are unsecured and are therefore very risky. There were significant defaults when credit cards were first issued en masse in the 1970s. Fair-Isaac was one of several companies to develop credit scores based on mathematical models that credit card lenders and others could use as inputs into their risk assessment models. Its “FICO” score, developed in the 1980s, became the standard measure for credit risk.²⁶ Some large lenders followed suit and developed their own scoring systems based on public information as well as relevant proprietary information they have available for clients.²⁷ As we document below, steady refinements of these risk assessment models have proved critical in enabling credit card issuers to expand credit to an ever wider group of Americans.

Automatic underwriting was adopted by the mortgage industry in the mid 1990s. Prior to automatic underwriting, all mortgages were evaluated by hand based on various guidelines. Automatic underwriting based on statistical models of credit default caught on quickly. By 2000, 60 to 70 percent of loans were evaluated based on these techniques.²⁸ Several factors were important to the growth of these automated risk analyses for mortgages. Studies found that the automatic techniques were able

(Federal Reserve Bank of Philadelphia, Working Paper, June 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=757929. See also Ben S. Bernanke, Chairman, Fed. Reserve, *Financial Innovation and Consumer Protection*, Keynote Address at the Federal Reserve System’s Sixth Biennial Community Affairs Research Conference (Apr. 17, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm> (last visited Feb. 10, 2010).

²⁶ The FICO scoring system compiles information from a variety of sources such as public records, credit application reports and awards points, using mathematical models, for a number of factors that can help predict the likelihood of a person repaying debts on time (e.g. length of credit history, types of credit used, amounts owed). The total number of these points - the credit score - predicts how creditworthy a person is. See History of Fair Isaac Corporation, available at <http://www.fico.com/en/Company/Pages/history.aspx> (last visited Feb. 10, 2010).

²⁷ Consumer Federation of America, *Fair Isaac Corporation, Your Credit Score*, available at http://www.pueblo.gsa.gov/cic_text/money/creditscores/your.htm (last visited Feb. 10, 2010).

²⁸ John W. Straka, *A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations*, 11 JOURNAL OF HOUSING RESEARCH 207, 216 (2000), available at http://www.knowledgeplex.org/kp/text_document_summary/scholarly_article/refiles/jhr_1102_straka.pdf (last visited Feb. 10, 2009).

to reliably identify a larger pool of credit-worthy candidates and do so at a lower cost than human underwriters. These automated techniques also enabled the lenders to better verify origination decisions and to reduce adverse selection problems. These techniques further reduced opportunities for discrimination against minorities because the algorithms were “color blind” and did not factor race or ethnicity information into the calculus. The significant expansion in mortgage lending to African Americans that we document below was due at least in part to the development of these automatic underwriting techniques.²⁹

Other types of credit also benefited from the development of sophisticated risk analysis. Overdraft protection, which allows consumers to receive an advance from the bank when a check they write exceeds the available funds in their account, has also benefited from technological innovation. Historically, financial institutions relied primarily on individual judgment to guide whether to pay checks that would overdraw a consumer’s account. Recently, however, this process has been automated by financial institutions. Customers who meet the bank’s predetermined thresholds, which are based on the bank’s risk analysis calculations, are approved instantly. The speed and the relatively low cost of automated approval also allows banks to extend this service to non-check transactions including ATM withdrawals and debit card transactions. As Federal Reserve Board Chairman Ben Bernanke remarked: “Although institutions usually charged the same amount when they paid an overdraft as when they returned the check unpaid, many consumers appreciated this service because it saved them from additional merchant fees and the embarrassment of a bounced check.”³⁰ Of course, there are legitimate controversies over whether consumers receive adequate notification of the fees they are required to pay for overdraft protection. But consumers largely benefit – they escape public embarrassment or general uneasiness from inability to make a purchase – when their checking account balances are temporarily low.

Automobile loans have also become more accessible to consumers because of developments in credit scoring and risk analysis. For example, the process for approving an auto loan has been reduced to hours or minutes instead of days and weeks. By 2001, 84 percent of automobile loan applicants in the United

²⁹ *Id.* at 227.

³⁰ *See* Bernanke, *supra* note 25, at 1.

States received a decision within an hour while 23 percent of applicants received a decision in less than 10 minutes.³¹

ii. Securitization

Before the development of securitization, lenders generally held onto loans they financed. This limited total bank lending to a multiple of their capital and also exposed these lenders to considerable variety of risks — such as events like a plant closing in the community served by a small bank — that affected many of the loans in the lenders' portfolios. With securitization, the originators of loans were able to sell off some or all of their loans to other market participants and thereby diversify their risks. Moreover, by creating a security instrument that consisted of a portfolio of loans, it became possible to sell these instruments to the emerging global capital markets. Doing so increased the supply of funds that were available for lending; with the loan removed from the bank's books, the bank had funds freed up to lend to more customers.

Securitization has experienced tremendous growth since it was introduced in the 1970s, expanding from mortgage loans to encompass a wide range of financial assets, including automobile loans and leases, student loans, credit card loans, and small business loans. The value of outstanding mortgage-backed securities increased from \$6.6 trillion in 2004 to \$8.9 trillion in 2008 (in constant 2008 dollars).³² Similarly, securitization of other types of loans such as automobile, credit card, home equity, manufacturing, and student loans grew from \$528 billion in 1996 to \$2.7 trillion in 2008 (in constant 2008 dollars).³³

³¹ Michael E. Staten & Fred H. Cate, *The Impact of National Credit Reporting Under the Fair Credit Reporting Act: The Risk of New Restrictions and State Regulation*, FINANCIAL SERVICE COORDINATING COUNCIL (2003), available at <http://www.sifma.org/regulatory/privacy/pdf/FSCCBenefitsCreditReporting.pdf> (last visited Feb. 10, 2010).

³² Securities Industry and Financial Markets Association, *Mortgage-Backed Securities Outstanding*, http://www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_USMortgageRelatedOutstanding.pdf (last visited Feb. 10, 2010). Numbers are converted into constant 2008 dollars using GDP deflator series from the Gross Domestic Product: Implicit Price Deflator. See Bureau of Economic Analysis, *Gross Domestic Product: Implicit Price Deflator*, available at <http://research.st.ouisfed.org/fred2/data/GDPDEF.txt> (last visited Feb. 10, 2010), (outlining data last updated August 27, 2009).

³³ Securities Industry and Financial Markets Association, *Asset-Backed Securities Outstanding*, http://www.sifma.org/research/pdf/ABS_Outstanding.pdf (last visited Sept. 6, 2009). Numbers are converted into

iii. Breakdowns in the Subprime Mortgage Market

The subprime mortgage crisis revealed significant breakdowns in financial institutions' application of both risk analysis and securitization. Loan-to-value ratios increased, a greater fraction of households received mortgages that were interest only, and more households received mortgages without having full documentation. Mortgage brokers, who relied heavily on commission, increasingly overlooked warning signs in submitting loan applications from "unqualified" clients.³⁴ Most importantly, the financial institutions that purchased these subprime mortgages and packaged them into securities, the credit agencies that rated these securities, and the investors who bought these securities did not account for the possibility of a significant slowdown or decline in the change in housing prices. A broad-based decline in housing prices cannot be diversified away by pooling mortgages because all of these loans would be uniformly affected by this "correlated risk". The decline in housing prices, combined with the fact that many of the sub-prime mortgages needed to be refinanced after two to three years, resulted in a massive increase in defaults. The foreclosure rate for adjustable rate subprime mortgages increased from a mere 3 percent in 2005 to over 8 percent in 2007.³⁵

constant 2008 dollars using GDP deflator series from the Gross Domestic Product: Implicit Price Deflator. See Bureau of Economic Analysis, Gross Domestic Product: Implicit Price Deflator (last visited Sep. 10, 2009) (outlining data last updated August 27, 2009).

³⁴ It appears, however, that the financial markets took these individual risks into account by demanding significant interest rate premiums on these loans that could cover significant defaults. What they did not take into account was the possibility of declines in housing prices that would result in correlated risks across individuals. For a lengthier discussion of this topic, see Dwight M. Jaffee, *The U.S. Subprime Mortgage Crisis: Issues Raised and Lessons Learned*, Commission on Growth and Development, Working Paper No. 28 (2008), available at <http://www.growthcommission.org/storage/cgdev/documents/gcwp028web.pdf>

³⁵ Staff of J. Econ. Comm., 110th Cong., THE SUBPRIME LENDING CRISIS, REPORT AND RECOMMENDATIONS BY THE MAJORITY STAFF OF THE JOINT ECONOMIC COMMITTEE 27 (Comm. Print. 2007), available at <http://www.gfoa.org/downloads/CongressSubprimeReport.pdf>. For more information on default details rates of subprime loans by origination year, see James R. Barth, Tong Li, Triphon Phumiwasana, & Glenn Yago, *Perspectives on the Subprime Market* (Milken Institute Working Paper, January 2008), available at <http://ssrn.com/abstract=1070404>.

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The problems from the increase in default rates were exacerbated by the fact that many of the large financial institutions that packaged the loans kept a significant portion of the loans on their own books rather than selling them into the global markets as the basic thesis of securitization suggested they should have done.³⁶ These institutions therefore had a concentration of what had become toxic assets.³⁷

In conclusion, this review of enhanced risk analysis and securitization has shown that these innovations helped expand the supply of credit overall and made it available to an ever wider portion of the American public. As the Chairman of the Federal Trade Commission noted, “Many fail to appreciate that the average American today enjoys access to credit and financial services, shopping choices, and educational resources that earlier Americans could never have imagined.”³⁸ Before we document these effects we describe additional innovations for several important types of consumer financial products.

B. Financial Innovations for Individual Consumer Financial Products and Services

i. Mortgages

Although consumers could easily finance the purchase of sewing machines by the early 20th century, they still had great difficulty financing the purchase of homes. Residential mortgages were only available for 5 to 10 years after which the principal became due and the borrower had to refinance.³⁹ Rates were variable, and loan-to-value ratios were below 50 percent. Relatively few Americans could finance the purchase of homes. This situation changed largely as a result of the creation of federally sponsored mortgage insurance in response to the

³⁶ See Dwight Jaffee, *supra* note 34, at 28. See also Dwight M. Jaffee et al., *Mortgage Origination and Securitization in Financial Crisis*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 72 (Wiley Finance 2009).

³⁷ *Id.*

³⁸ Timothy J. Muris, Chairman, Fed. Trade Comm’n, Protecting Consumers’ Privacy: Goals and Accomplishments, Remarks at the Networked Economy Summit (June 11, 2002), available at <http://www.ftc.gov/speeches/muris/gmason.shtm>.

³⁹ Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. OF ECON. PERSPECTIVES 93 (2005).

housing collapse following the 1929 stock market crash.⁴⁰ This insurance enabled banks to issue long-term fixed rates mortgages. After World War II these new mortgages enabled millions of Americans to finance homes during the economic expansion that started in the early 1950s. The number of American households who owned homes increased from 23.9 million in 1950 to 36.3 million in 1965 to 78.7 million in 2008. Increases in the supply of mortgage lending successively enabled the post-World War II generation, the large baby boom generation, and Generation X to buy and finance homes.

The stagflation years of the 1970s brought considerable problems to the housing market. High interest rates led depositors to move funds from banks that had regulatory ceilings on the rates they could pay depositors to treasury securities and other instruments. Depositors, meanwhile, had been a major source of mortgage funding. At the same time, high interest rates on fixed rate mortgages put home ownership out of the reach of many Americans. Efforts to introduce adjustable rate mortgages during the 1970s met with considerable opposition from consumer groups, and regulators imposed tight restrictions on allowable changes in the interest rates.⁴¹ As a result, many Americans who wanted to buy homes were not able to do so at fixed rate mortgage terms. They were liquidity constrained.⁴²

Although inflation was tamed by the early 1980s, and interest rates began coming down significantly thereafter, there was concern that the future would bring significant volatility in interest rates that would put lenders at risk, and thereby curtail mortgage lending to households. The main innovation that was introduced was the 30-year adjustable rate mortgage (ARMs) that would allow mortgage earnings to keep pace with the cost to

⁴⁰ As with the current crisis, housing prices fell during the Great Depression, forcing homeowners to walk away from their loans which resulted in banks selling foreclosed homes, further driving down home prices.

⁴¹ Kristopher Gerardi, Harvey S. Rosen, & Paul Willen, *Do Households Benefit from Financial Deregulation and Innovation? The Case of the Mortgage Market* (Federal Reserve Bank of Boston, Public Policy Discussion Papers, June 2006), available at <http://www.bos.frb.org/economic/ppdp/2006/ppdp066.pdf>.

⁴² Many lenders holding portfolios of fixed rate mortgages sustained major losses when interest rates climbed and the rates they paid for funds were well above what they earned. The interest rate inversion of the last years of the 1970s and the first years of the 1980s was at the core of the savings and loan crisis of the 1980s.

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lenders of funding those mortgages.⁴³ Home purchasers found these mortgages appealing because they were usually set at short-term interest rates, which were substantially lower than long-term interest rates and reflected risk premiums for future inflation. Over the course of the 1980s a significant part of new mortgage loans were ARMs, reaching a peak of 58 percent in 1988 as shown in Table 3. Many households benefited from the ARMs because interest rates ended up declining in subsequent years.

Table 3. Loans with adj. mortgage rates as proportion of all loans, 1984-2003.

Year	Proportion of all loans
1985	50%
1986	30%
1987	43%
1988	58%
1989	38%
1990	28%
1991	23%
1992	50%
1993	20%
1994	39%
1995	32%
1996	27%
1997	22%
1998	12%
1999	21%
2000	24%
2001	12%
2002	17%
2003	19%

Source: Monthly Interest Rate Survey, Table 34, Federal Housing Finance Board; <http://www.fhfa.gov/Default.aspx?Page=252>.

As long-term interest rates declined, more home buyers and households who were refinancing mortgages shifted back to fixed rate mortgages.

Other innovations were also introduced. These included ARMs with fixed interest rates for several years, graduated payment mortgages, mortgages that allowed initial payments to

⁴³ Congressional legislation was passed in 1981 to allow S&Ls to invest in ARMs, which stimulated their supply.

fall below interest charges, and low down payment mortgages. As Professor Jaffee observes, "These mortgages were all designed to meet specific needs: option mortgages for borrowers with widely fluctuating incomes, converting ARMs for borrowers who expect a rising income profile, and so on."⁴⁴

Securitization was another major innovation in the mortgage industry. It was responsible for expanding the source of capital to make it possible for millions of young Americans, especially those coming into the labor market and forming households, to buy homes. Freddie Mac was created in 1970 and was charged with creating a more liquid market for mortgages.⁴⁵ As discussed, mortgage-backed securities emerged and started becoming popular in the 1980s. These securities allowed financial institutions to better diversify their risks by selling some portion of mortgage loans they had originated. As importantly, they broke the dependence of the supply of mortgages on the supply of deposits. Banks could receive compensation for originating and then servicing loans by selling mortgage backed securities. The mortgage originators increasingly became intermediaries between mortgage borrowers and the global capital markets, which vastly expanded the amount of liquidity available to borrowers.⁴⁶

A significant portion of the American population was, nevertheless, still unable to get mortgages in the 1980s. Lower income individuals, people who had not established a credit history, possibly because of having faced adverse economic circumstances, and people with poor credit histories were shut out of the mortgage lending market. They comprised a substantial portion of the 20 percent of households that were liquidity constrained. The U.S. government encouraged financial institutions to expand lending to these groups for a variety of policy reasons.⁴⁷ Computerized risk analysis and securitization made the expansion of lending to this underserved part of the population possible.

Subprime mortgages expanded in the last half of the 1990s

⁴⁴ See Jaffee, *supra* note 34, at 14.

⁴⁵ See Freddie Mac Corporate History, http://www.freddiemac.com/news/corp_facts.html (last visited Sept. 6, 2009).

⁴⁶ Between 1980 and 2008 the share of home mortgages that were held by the originating institution declined from 89% to 41%. Meanwhile, the share of mortgages that were securitized increased from 11% to 59%. See James R. Barth et al., *Mortgage Market Turmoil: The Role of Interest-Rate Resets*, 2 GH BANK HOUSING J. 17 (2007), at 24.

⁴⁷ Lyons, *supra* note 24, at 231-32.

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and especially rapidly in the first half of the 2000s. In 1994, only 5 percent of the mortgages that were originated were subprime. Subprime originations grew to 13 percent in 2000 and reached 20 percent in 2005 and 2006.⁴⁸ Then the housing bubble burst. Subprime originations declined sharply, falling to less than 1 percent of all originations in the last quarter of 2008. Although there were serious problems in the subprime mortgage market, as discussed below, these mortgages helped a significant number of socially and economically disadvantaged households, most of whom did not have access to credit, to buy their homes. More importantly, going forward, it is essential to distinguish between subprime mortgage lending and the housing bust. Housing prices will eventually reach a new equilibrium that reflects their fundamental value and may experience normal appreciation thereafter⁴⁹ So long as subprime mortgages reflect the realities of the housing market, they can enable many socially and economically disadvantaged individuals to obtain home loans that they would not otherwise be able to get.

ii. Non-Mortgage Lending

As discussed, consumers borrow money to help smooth out consumption and income over their lifecycles. Importantly, they borrow to purchase consumer durables ranging from televisions to automobiles. American consumers have seen over the nation's history a steady increase in their ability to borrow to finance current consumption as a result of innovations in consumer financial products and services. Over time, these innovations have provided more credit at cheaper costs to consumers. With each new innovation, more credit-worthy borrowers have been able to transition from more costly credit to less expensive forms of credit as we show below.

During the great economic expansion of the 19th century, American consumers saw rising incomes over their lifetimes; as a result, Americans enjoyed an increasing array of consumer products available to them.⁵⁰ As the century progressed, retailers

⁴⁸ Barth et al., *supra* note 35, at 3.

⁴⁹ Between June 2001 and June 2009 home prices appreciated at the rate of inflation with the gains from the boom being largely offset by the bust. See Floyd Norris, *After a Bumpy Ride, Back at Square One*, N.Y. TIMES, Aug. 28, 2009, at B3, available at <http://www.nytimes.com/2009/08/29/business/economy/29charts.html> (last visited Feb. 9, 2010).

⁵⁰ See THE ECONOMICS OF CONSUMER CREDIT, *supra* note 20, at ch. 9.

became significant providers of credit to consumers. Retailers allowed customers to put such purchases on a “house charge” to be paid at the end of the month and they sold products on installment plans that allowed consumers to pay over time.⁵¹ As of 1929, retailers were the primary suppliers of consumer credit, accounting for more than 60 percent of consumer credit with financial institutions providing the remainder.⁵² By 1929, a fifth of all retail sales were carried on open accounts — a type of revolving credit —and that share remained roughly steady until after World War II.⁵³ Retail credit was expensive by modern standards.⁵⁴

Retail credit was also limited and highly restricted. Retailers gave customers identification cards that they could use when they charged merchandise. But generally these cards could only be used to pay at the retailer that issued the card, or in some cases, groups of retailers that agreed to use a common card. A key innovation occurred in 1950 when Diners Club introduced the general-purpose charge card, which consumers could use at many unrelated merchants.⁵⁵ Diners Club provided the financing for the merchant *and* collected from the cardholder. Like the house charge programs, the cardholder paid at the end of the month. American Express introduced a similar product in 1958; and, by the end of the 1950s, charge cards were widely accepted by merchants and carried by millions of Americans (principally well-off businessmen).⁵⁶

In 1958, Bank of America introduced the modern general-purpose credit card. It allowed consumers to finance their purchases over time on a revolving line of credit.⁵⁷ This feature substituted for the various credit programs offered by retailers. At the time, Bank of America could only operate in California because of interstate banking regulations.⁵⁸ Soon, similar cards were being introduced and circulated by other banks around the

⁵¹ Until 1916, most states had usury laws that limited the ability of financial institutions to lend profitably to consumers. Retailers could effectively lend, and thus bypass these usury laws, by including the cost of the loan (including the risks of nonpayment) in the purchase price. *See, e.g., id.*

⁵² *Id.* at 309.

⁵³ *Id.*

⁵⁴ *Id.* at 308.

⁵⁵ *See* David S. Evans & Richard Schmalensee, *Paying with Plastic: The Digital Revolution in Buying and Borrowing*, 53-54 (MIT Press 2005).

⁵⁶ *Id.* at 58.

⁵⁷ *Id.* at 56-57

⁵⁸ *See, e.g., id.*

country. The modern credit card industry, however, did not really take off until the early 1980s. State usury laws had significantly constrained the expansion of credit cards during the 1970s because the cost of capital was too high to enable banks to profitably extend credit at the interest rates allowed in many states.⁵⁹ This changed in 1978 when a Supreme Court decision allowed banks to issue nationally without being subject to these state restrictions.⁶⁰ That decision, together with the economic expansion that began in the early 1980s, allowed the development of a robust national market for credit cards.

Over time, both computerized risk analysis and securitization became important factors in helping to increase the supply of revolving credit. Crude risk analysis methods tended to deny credit to many people who failed to meet certain thresholds. More refined risk analysis made it possible to issue credit to a wider group of individuals. These individuals usually paid higher fees, including higher interest rates because they had greater expected default rates and other payment-related problems. Lenders, therefore, developed various pricing plans to accommodate these expanding categories of borrowers.

The increased availability of credit cards has also provided significant benefits to small businesses. Almost half of firms with fewer than 20 employees use personal credit cards to help finance their businesses.⁶¹ That has enabled small businesses, especially new companies that do not have a significant credit history, to obtain sources of working capital as well as longer term loans.⁶² Smaller retailers have also benefited from the expansion of credit cards. Larger retailers can afford to offer store cards along with other lending programs such as installment sales; smaller firms, however, typically lack the financial resources or the scale to offer their consumers credit. The

⁵⁹ See Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201 (1986).

⁶⁰ *Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 318 (1978).

⁶¹ BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT TO THE CONGRESS ON THE AVAILABILITY OF CREDIT TO SMALL BUSINESSES 30 (2007), http://www.federalreserve.gov/board_docs/rptcongress/smallbusinesscredit/sbfreport2007.pdf (last visited Feb. 9, 2010). Almost 47% of businesses with fewer than 500 employees rely upon personal credit cards. *Id.*

⁶² See EVANS & SCHMALENSEE, *supra* note 55, at 107-114; see also David Blanchflower & David S. Evans, *The Role of Credit Cards in Providing Financing for Small Businesses*, 77 THE PAYMENT CARD ECONOMICS REVIEW 77 (2004), available at <http://ssrn.com/abstract=1474450>.

widespread availability of consumer credit from third parties has therefore benefited smaller retailers and helped level the playing field with larger retailers.⁶³

There are debates surrounding whether Americans took on too much debt as a result of the availability of credit cards and over some of the pricing practices of the card issuers. These are valid concerns that lie outside the scope of this paper and which have been addressed by recent legislation and regulation. However, it is important to recognize that despite these issues, a vast number of Americans have benefited from expanded access to loans which have enabled them to deal with emergencies and smooth out consumption over their lifecycles. As noted below, it has also enabled consumers to shift borrowing from more expensive retail loans. For example, if credit cards were banned, or sharply curtailed, many consumers would be buying furniture on installment plans from retailers and paying much more in the end than they pay with credit cards. Other consumers would turn to payday lenders, pawn shops, and loan sharks.

Another major innovation was home equity loans, which were introduced in the late 1970s.⁶⁴ At that time, many households had realized large increases in the value of their homes. But their investments in their homes were illiquid. To borrow, these households used primarily credit vehicles, such as credit cards, that did not require collateral and therefore had relatively high interest rates. With the house serving as collateral, home equity loans allowed Americans to borrow against the equity they had built up in their houses and at lower rates than many other forms of credit. The value of home equity lines increased from around \$322 billion in 1990 to over \$1.1 trillion in 2008 (in constant 2008 dollars).⁶⁵

Computerized risk analysis and securitization facilitated the expansion of other forms of credit from the early 1980s to the present. For example, automobile loans, for which the loan-to-

⁶³ EVANS & SCHMALENSEE, *supra* note 55, at ch.3.

⁶⁴ Louise Story, *Home Equity Frenzy Was a Bank Ad Come True*, N.Y. TIMES, Aug. 15, 2008, at A1.

⁶⁵ Press Release, Federal Reserve Board of Governors, *Flow of Funds Accounts of the United States* (Sept. 18, 2008), available at <http://www.federalreserve.gov/releases/z1> (last visited Feb. 10, 2010). Numbers are converted into constant 2008 dollars using GDP deflator series from Bureau of Economic Analysis, Gross Domestic Product: Implicit Price Deflator, Bureau of Economic Analysis, last updated Aug. 27, 2009 available at <http://research.stlouisfed.org/fred2/data/GDPDEF.txt> (last visited Feb. 10, 2010.)

value ratio is typically around 90 percent, increased from about \$254 billion in 1980 to \$584 billion in 1999 (in constant 2008 dollars).⁶⁶

The expansion of non-mortgage credit as a result of the introduction of innovative methods of lending has enabled consumers to substitute less expensive for more expensive forms of credit. Although there is no hard evidence we are aware of, it is likely that the introduction by retailers of house charges and revolving loans reduced the reliance of 19th century consumers on the main alternative forms of credit - pawn brokers and loan sharks. As a result, and most significantly, charge and credit cards displaced retail credit. Between 1968 and 2008 the fraction of non-mortgage debt from retailers declined from 17 percent to about 2 percent while the fraction based on credit cards increased from 1.3 percent to 38.1 percent of consumer credit.⁶⁷ Credit cards generally offered better financing terms than store programs as well as greater variety and portability. When home equity loans became available, consumers substituted this cheaper form of lending for borrowing on credit cards.⁶⁸ Rates on home equity lines are typically lower than those on credit cards, and they offer tax benefits.⁶⁹ This made borrowing against a person's existing home for non-housing consumption more common.⁷⁰ Of course, as

⁶⁶ For 1980 numbers, see Federal Reserve Bank of St. Louis, Economic Research, Series: AUTONS, Total Automobile Credit Outstanding, available at <http://research.stlouisfed.org/fred2/series/AUTONS>. For 1999 numbers see Federal Reserve Statistical Release G19 (June 7, 1999), available at <http://www.federalreserve.gov/releases/g19/19990607/> (last visited Feb. 10, 2010). Numbers are converted into constant 2008 dollars using GDP deflator series from Bureau of Economic Analysis, *supra* note 65. More recent data on the total amount of automobile loans outstanding is not publicly available.

⁶⁷ Federal Reserve Statistical Release G19, Consumer Credit Historical Data, available at <http://www.federalreserve.gov/releases/g19/hist/> (last visited Feb. 10, 2010).

⁶⁸ Michael E. Staten, *Consumer Debt: Myths about the Impact of the Recession*, CREDIT RESEARCH CENTER REPRINT #21 (1993), available at <http://faculty.msb.edu/prog/CRC/publications2.html> (last visited Feb. 9, 2010).

⁶⁹ According to Bloomberg, the average lowest credit card rate was 11.25 percent as of August 19, 2009, while the rate for home equity loans was 8.55 percent according to www.bankrate.com. Jeff Plungis, *Consumer Gains on Credit-Card Law Pared by Rate Hikes*, BLOOMBERG.COM, Aug. 19, 2009, available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=aBKkB081ypy4> (last visited Feb. 10, 2010).

⁷⁰ Barry Z. Cynamon & Steve M. Fazzari, *Household Debt in the Consumer Age: Source of Growth - Risk of Collapse*, 3 CAPITALISM & SOC'Y 1 (2008), available at <http://www.bepress.com/cas/vol3/iss2/art3> (last visited Feb. 10, 2010).

housing values have declined, we would expect that the home equity trend will diminish as more consumers go back to credit cards.

C. The Effects of Financial Innovation on the Expansion and Democratization of Credit

Financial innovations have helped relax liquidity constraints on millions of Americans who would not have had access to credit at all or would not have been able to get as much credit as they desired. Professor Lyons found that in 1998, American households were able to obtain 68.3 percent of the credit they wanted; up from 55.5 percent in 1983.⁷¹ That trend has likely continued given the effects of the innovations discussed above. As we demonstrate, access to credit has expanded socially and economically to groups that are most likely to be liquidity constrained.

i. Home Ownership

The growth rate in home ownership for several socially and economically disadvantaged groups increased more rapidly than the growth rate for better-situated groups between the late 1980s and the late 2000s. Between 1995 and 2008, the rate of growth of home ownership for African Americans and Hispanics was 11.0 percent and 16.6 percent respectively, compared to 5.8 percent for whites.⁷²

This increase in home ownership for individuals trapped in the bottom fifth of the income distribution can be attributed largely to greater sources and access to credit capital. Between 1989 and 2007, as illustrated in Table 4, the percent of families who owned a primary residence in the bottom quintile of the income distribution increased from 32.9 to 41.4 percent (a change of 8.5 percentage points); that compares with an increase from 65.4 to 69.3 percent (a change of 3.9 percentage points) for households in the middle quintile of the income distribution.

⁷¹ Lyons, *supra* note 24, at 248.

⁷² The percentage of African American homeowners grew from 42.7 percent in 1995 to 47.4 percent in 2008; the percentage of Hispanic homeowners grew from 42.1 percent to 49.1 percent; the percentage of white homeowners increased from 70.9 percent to 75 percent. See U.S. Census, HOMEOWNERSHIP RATES BY RACE AND ETHNICITY OF HOUSEHOLDER: 1994 TO 2008, www.census.gov/hhes/www/housing/hvs/annual08/ann08t22.xls.

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Thus, the increase in home ownership was almost twice as high for the low income group compared to the middle income group. Consequentially, the gap between the bottom bracket and the middle income categories decreased from 32.5 percent points (65.4 - 32.9) to 27.9 percentage points.

The percent of home ownership for single parents increased from 42.7 percent to 49.1 percent (falling from a peak of 54.5 percent in 2004 before the housing collapse started), while the percent of home ownership among families with children remained roughly constant between 1989 and 2007 (increasing slightly from 77.5 percent to 78.0 percent). The increase of 6.4 percentage points in home ownership for single parents was more than 12 times higher than the 0.5 percentage point increase for parents with children.

Table 4. Percent of families with primary residence, by racial, family structure, and income characteristics

Year	Race or ethnicity		Family structure		Percentile of income		Age of head	
	White, non Hispanic	Nonwhite or Hispanic	Single with children	Couple with children	Bottom	Middle	< 35	45 - 54
1989	70.5	44.4	42.7	77.5	32.9	65.4	39.4	76.5
1992	70.3	44.4	43.0	74.6	38.9	61.8	36.8	75.4
1995	70.6	44.3	46.8	74.6	39.7	62.6	37.9	75.3
1998	72.0	47.2	46.9	79.1	38.8	67.3	38.9	74.4
2001	74.3	47.3	48.5	78.7	40.6	66.0	39.9	76.2
2004	76.1	50.8	54.5	77.8	40.3	71.6	41.6	77.3
2007	75.6	51.9	49.1	78.0	41.4	69.3	40.7	77.3

Note: Bottom percentile is for people in the lowest 20 percent and middle quintile is for people in 40-59 percent range.

Source: THE FEDERAL RESERVE BOARD, 2007 SURVEY OF CONSUMER FINANCE, (2009), <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf>.

Between 1989 and 2007, all groups experienced an increase in the value of their homes. As reported by the Survey of Consumer Finances, the gap between the value of the homes afforded by lower and middle class people shrunk between 1989 and 2007.⁷³ In 1989, the average value of the home for the lowest

⁷³ Federal Reserve Board of Governors, Survey of Consumer Finance, 1992-2007, available at <http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html> (last visited Feb. 9, 2010).

income quintile was half of the value of a home for the middle quintile.⁷⁴ In 2007, the median home value for the lowest quintile is only 50 percent lower than that for the middle.⁷⁵ The median value of the home owned by African Americans and Hispanics increased by 125 percent compared to an increase of only 66 percent for the value of homes owned by white people.⁷⁶

These increases in home ownership were made possible because of the increased availability of mortgage finance. Table 5 shows the percent of households with mortgages or home equity loans for each of the groups discussed above. Between 1989 and 2007 the share of Hispanics and African Americans with mortgages increased 10.6 percentage points (39.2-28.6) compared to an increase of 7.2 percent points for white. Similarly, the percent of lower income people with mortgages almost doubled from 7.5 percent to 13.7 percent.

Table 5. Percent of families with mortgages or home-equity loans

Year	Race or ethnicity		Family structure		Percentile of income		Age of head of house	
	White, non Hispanic	Nonwhite or Hispanic	Single with children	Couple with children	Bottom	Middle	< 35	45 - 54
1989	42.0	28.6	30.8	62.2	7.5	37.3	34.9	56.9
1992	42.1	27.3	28.3	63.2	10.4	35.4	30.9	59.4
1995	43.3	30.2	32.0	63.0	10.4	37.7	32.9	61.1
1998	45.5	30.3	28.9	65.5	10.8	42.5	32.9	57.6
2001	46.1	35.1	34.1	67.0	12.8	43.1	35.6	58.7
2004	49.7	36.3	41.3	66.5	14.6	50	37.7	62.5
2007	49.2	39.2	37.0	67.8	13.7	48.8	37.1	63.8

Note: Bottom percentile is for people in the lowest 20 percent and middle quintile is for people in 40-59 percent range.

Source: 2007 Survey of Consumer Finance, The Federal Reserve Board (June 15, 2009), available at <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf>.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

ii. Access to Non-Housing Credit

Socially and economically disadvantaged groups also secured greater access to non-mortgage credit between 1989 and 2007. Tables 6-9 summarize the changes and overall growth rates for the groups discussed above for automobile ownership, education loans, credit card loans and home equity loans.

Between 1989 and 2007, the percentage of non-white households with automobile loans increased from 29.3 percent to 33.3 percent while the share of white households with auto loans decreased slightly following a peak of 37.4 percent in 2004 (see Table 6). The share of single parents with vehicles loans increased from 26.9 percent to 28.3 percent while the share of married couples with car loans dropped to 50.4 percent following an increase to 51.1 percent in 2004. Similar observations can be made for lower income and younger people.

Table 6. Percent of families with vehicle installment loans

Year	Race or ethnicity		Family structure		Percentile of income		Age of head	
	White, non Hispanic	Nonwhite or Hispanic	Single with children	Couple with children	Bottom	Middle	< 35	45 - 54
1989	36.6	29.3	26.9	50.7	11.5	41.5	37.8	47.6
1992	31.4	24.9	25.1	44.1	10.0	33.5	36.6	34.6
1995	32.9	27.6	24.0	47.6	11.2	34.3	40.1	37.9
1998	32.0	29.4	27.1	44.2	12.4	37.1	36.9	40.1
2001	35.9	32.1	34.5	50.9	12.3	42.0	45.0	37.8
2004	37.4	30.9	30.9	51.1	12.8	43.6	41.3	39.0
2007	35.5	33.3	28.3	50.4	13.0	41.1	44.3	39.1

Note: Bottom percentile is for people in the lowest 20 percent and middle quintile is for people in 40-59 percent range.

Source: THE FEDERAL RESERVE BOARD, 2007 SURVEY OF CONSUMER FINANCE, (2009), <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf>.

The increased access to credit also provided minority groups with improved access to education loans as evidenced by

Table 7. Between 1989 and 2007, the proportion of non-white households holding education loans increased 7.7 percent points (from 10.8 percent to 18.5 percent) compared with an increase of only 5.6 percent points for white households (from 8.3 percent to 13.9 percent).

Table 7. Percent of families with education installment loans

Year	Race or ethnicity		Family structure		Percentile of income		Age of head	
	White, non Hispanic	Non-white or Hispanic	Single with children	Couple with children	Bottom	Middle	< 35	45 - 54
1989	8.3	10.8	17.0	8.9	8.4	7.7	17.1	7.3
1992	10.8	10.3	15.0	13.5	10.6	14.1	24.3	5.4
1995	11.6	12.7	13.7	17.3	9.5	11.4	24.4	11.3
1998	11.4	11.4	13.6	14.4	9.9	11.7	23.6	10.3
2001	11.2	13.5	14.3	14.9	7.7	13.6	26.1	11.0
2004	13.7	12.9	14.4	18.0	10.9	15.8	28.6	12.6
2007	13.9	18.5	20.2	20.7	10.7	16.6	33.8	14.5

Note: Bottom percentile is for people in the lowest 20 percent and middle quintile is for people in 40-59 percent range.

Source: THE FEDERAL RESERVE BOARD, 2007 SURVEY OF CONSUMER FINANCE, (2009), <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf>.

The gap between minority groups holding credit cards and the rest of the population also declined. The gap in having revolving credit between white and nonwhite households disappeared between 1989 and 2007. Meanwhile, the gaps between single parents and couples with children and between the lowest and middle income quintiles also declined dramatically over this period as shown on Table 8.

Table 8. Percent of families with credit card balances

Year	Race or ethnicity		Family structure		Percentile of income		Age of head	
	White, non Hispanic	Nonwhite or Hispanic	Single with children	Couple with children	Bottom	Middle	< 35	45 - 54
1989	41.5	34.4	35.6	53.8	15.3	48.9	44.5	49.3
1992	44.2	42.1	43.3	56.0	23.4	51.9	51.8	48.9
1995	47.1	48.0	43.9	60.9	26.0	52.9	54.7	56.4
1998	44.3	43.5	38.0	55.8	24.5	50.1	50.7	52.5
2001	43.3	47.6	48.1	52.4	30.3	52.8	49.6	50.4
2004	46.0	46.7	48.6	56.7	28.8	55.1	47.5	54.0
2007	45.1	48.4	45.1	54.7	25.7	54.9	48.5	53.6

Note: Bottom percentile is for people in the lowest 20 percent and middle quintile is for people in 40-59 percent range.

Source: THE FEDERAL RESERVE BOARD, 2007 SURVEY OF CONSUMER FINANCE, (2009), <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf>.

Similar trends are also observed for home equity lines of credit. As homeownership increased and home equity lines of credit became available in the 1980s, more households were taking advantage of their home's equity (see Table 9). In 2007, 5.5 percent of non-white households had access to a home equity line versus only 1.2 percent in 1989. From 1989 to 2007, the proportion of single parents with home equity lines increased from 0.8 percent to 6.4 percent. Furthermore, a greater number of younger people were using home equity loans to finance purchases. In 2008, 4 percent of individuals under 35 had home equity lines of credit versus only 0.8 percent in 1989.

Table 9. Percent of families with home equity lines of credit

Year	Race or ethnicity		Family structure		Percentile of income		Age of head	
	White, non Hispanic	Nonwhite or Hispanic	Single with children	Couple with children	Bottom	Middle	< 35	45 - 54
1989	3.8	1.2	0.8	5.5	0.1	2.4	0.8	6.2
1992	5.2	1.4	1.3	7.0	0.0	3.7	1.1	8.3
1995	3.3	1.4	0.9	4.7	0.0	1.4	1.4	5.1
1998	5.0	2.6	2.7	7.4	0.5	3.3	1.4	7.9
2001	5.7	1.9	2.0	7.3	1.0	3.0	2.9	7.2
2004	10.5	3.6	5.6	13.6	1.3	7.1	3.5	13.1
2007	9.8	5.5	6.4	11.0	1.9	6.9	4.0	11.7

Note: Bottom percentile is for people in the lowest 20 percent and middle quintile is for people in 40-59 percent range.

Source: THE FEDERAL RESERVE BOARD, 2007 SURVEY OF CONSUMER FINANCE, (2009), <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf>.

D. The Effects of Financial Innovation on Economic Expansion and Job Growth

The increased supply of credit to households that began in the early 1980s helped spur economic expansion and job growth for several decades. Widespread increases in available credit created more funds available for consumption and investment, which then increased demand for goods. To meet this growing demand, firms start producing more goods, which created job opportunities; employment rates therefore rose along with wages, which increased overall disposable income to consumers. The increased income further stimulated consumption and supply of goods. Thus, the initial consumption stimulation started a cascading chain of further spending and subsequent production growth, which led to overall economic growth. Economists call this mechanism “the multiplier effect.”⁷⁷

⁷⁷ For more discussion about the multiplier effect, see generally PAUL SAMUELSON & WILLIAM NORDHAUS, *supra* note 17, at 446.

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IV. The Rationale for the Consumer Financial Protection Agency Act of 2009

Although consumer lending has benefited millions of Americans, it has not been without its problems. As with almost any industry, some firms engage in unscrupulous or even fraudulent practices. Some consumers borrow with incomplete or imperfect information. The U.S. Congress has passed numerous laws, including the Truth in Lending Act and the FTC Act, to regulate various aspects of lending including disclosure requirements. Various states have also passed laws to protect borrowers, including state consumer protection legislation, usury laws, and restrictions on payday lending and other forms of lending. As a result, consumer lending is already extensively regulated in the United States.

The U.S. Department of Treasury has proposed sweeping changes to this system of regulation. In announcing the plan, President Obama said that consumer financial protection was needed because “crisis was not just the result of decisions made by the mightiest of financial firms; it was also the result of decisions made by ordinary Americans to open credit cards and take out home loans and take on other financial obligations.”⁷⁸ The Treasury Department argued that mortgage companies as well as other financial firms sold products that “were overly complicated and unsuited to borrowers’ financial situation[s] . . . with disastrous results for consumers and the financial system.”⁷⁹ The Treasury Department’s report does not, however, provide evidence to support the naked assertion that failed consumer protection regulation played a significant factor in the financial crisis. Indeed, there is no evidence that we are aware of that such predatory lending or other practices that would violate consumer protection laws resulted in a significant portion of the loss in value of the mortgage-backed securities that were at the heart of the financial meltdown.⁸⁰ There is therefore little basis for

⁷⁸ Barack Obama, President of the United States, Speech on 21st Century Financial Regulatory Reform (June 17, 2009), *available at* http://www.cfr.org/publication/19658/obamas_speech_on_21st_century_financial_regulatory_reform.html.

⁷⁹ DEP’T OF THE TRES., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION, *available at* http://www.financialstabilit.gov/docs/regs/FinalReport_web.pdf.

⁸⁰ That is not to deny that some consumers *were* victims of unfair and deceptive practices in securing mortgages and that the regulatory agencies could and should have done a better job regulating the burgeoning subprime

concluding that increased consumer protection in the mortgage market would have prevented the financial crisis, that failed consumer protection was a significant cause of the financial crisis, or that the changes sought by the CFPB Act would have averted or even meaningfully reduced the harm from the financial crisis.

To the extent an intellectual case has been made for the new agency, it has been made by several law professors in a series of articles that appeared in 2008. Their arguments are largely based on a belief that consumers make poor choices when it comes to financial products and services. These professors also suggest that stronger consumer protection regulation could make these consumers better off by regulating the design of these products, mandating various disclosures, restricting consumer

mortgage market. There is no evidence that we are aware of, however, that a significant portion of the individuals who defaulted were victims of unscrupulous mortgage practices or that these individuals would have failed to take out mortgages in the absence of these practices. Oren Bar-Gill and Elizabeth Warren have argued that “the high proportion of people with good credit scores who ended up with high-cost mortgages raises the specter that some portion of these consumers were not fully cognizant of the fact that they could have borrowed for much less.” See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 39 (2008). They claim that many people who got sub-prime mortgages could have received less expensive prime mortgages. These authors do not provide any evidence that a significant number of homeowners that defaulted would not have done so had they paid lower interest rates. It is doubtful that there would have been fewer defaults since even with lower interest rates these homeowners would have had negative equity in their homes and therefore would gain from defaulting. In addition, a Federal Reserve Bank of Boston study finds that most subprime mortgage borrowers would not have received prime mortgages. Christopher L. Foote, Kristopher S. Gerardi, Lorenz Goette & Paul Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What We Don't* (Federal Reserve Board of Boston, Public Policy Discussion Paper No. 08-2, May 30, 2008), available at <http://ssrn.com/abstract=1153411>. Deterioration of the underwriting standards has also been put to blame for the current crisis. Another study at the Federal Reserve Bank of Boston found that loans issued in 2005–2006 were not very different from loans made earlier, which, in turn had performed well, despite carrying a variety of serious risk factors. While the 2005-2006 loans may have carried risk factors, such as increased leverage, underwriting standards alone cannot explain the dramatic rise in foreclosures. See Kristopher S. Gerardi, Andreas Lehnert, Shane Sherland & Paul Willen, *Making Sense of the Subprime Crisis* (Federal Reserve Board of Boston, Public Policy Discussion Paper No. 09-1, December 22, 2008), available at <http://ssrn.com/abstract=1341853>; see also Geetesh Bhardwaj & Rajdeep Sengupta, *Where's the Smoking Gun? A Study of Underwriting Standards for US Subprime Mortgages* (Federal Reserve Bank of St. Louis, Working Paper No. 2008-036B, Apr. 1, 2009), available at <http://ssrn.com/abstract=1286106>.

choice, and ‘nudging’ consumers toward certain standardized financial products.

The CFPA Act appears to have evolved from a May 2008 paper written by two law professors: Elizabeth Warren of Harvard⁸¹ and Oren Bar-Gill of New York University.⁸² They identified a series of problems with consumer financial products, argued that existing federal regulatory agencies lack the ability or motivation to deal with these problems, and proposed the creation of a new federal consumer financial protection agency.⁸³ Along with several co-authors, Michael Barr, a University of Michigan Law School professor who is now the Assistant Secretary of the Treasury involved in the draft legislation, expanded upon the proposed Bar-Gill/Warren agency by detailing key aspects of the regulatory approach the agency should take in an October 2008 paper.⁸⁴ Barr et al. proposed requiring that lenders offer standardized products designed by the agency regulators.⁸⁵ Further, Barr et al. would enable individuals to sue lenders if certain substantive terms of financial products, including disclosure terms, were deemed “unreasonable.”⁸⁶ These papers provide the articulated basis for understanding the rationale behind the CFPA Act as envisioned by its architects, insight into how the new agency would analyze consumer lending products, and a means to predict how the new agency would affect people’s access to consumer credit and their choice of products. In the absence of concrete guidelines specifying how the broad discretionary authority granted to the new agency will be exercised, these papers provide the most reliable basis to predict how the CFPA will operate in practice.

The proposed new consumer financial protection agency, as described by these authors, is based on the following set of

⁸¹ Elizabeth Warren is currently the head of the Congressional Oversight Panel on TARP funding.

⁸² See Bar-Gill & Warren, *supra* note 80. Bar-Gill and Warren’s case for the CFPA Act relies heavily on their previous work. See, e.g., Oren Bar-Gill, *Seduction By Plastic*, 98 NW. U. L. REV. 1373 (2004); Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY: J. OF IDEAS (2007), available at <http://www.democracyjournal.org/article.php?ID=6528>.

⁸³ Bar-Gill & Warren, *supra* note 80, at 26.

⁸⁴ Michael S. Barr, Sendhil Mullainathan, & Eldar Shafir, BEHAVIORALLY INFORMED FINANCIAL SERVICES REGULATION (New American Foundation Working Paper, 2008), http://www.newamerica.net/files/naf_behavioral_v5.pdf.

⁸⁵ *Id.* at 7-9.

⁸⁶ *Id.* at 9, 15.

presumptions concerning consumer behavior, markets, and regulation:

- “[m]any consumers are uninformed and irrational,”⁸⁷
- “consumers make systematic mistakes in their choice of credit products and in the use of these products,”⁸⁸ and,
- regulations should adopt a number of “behaviorally informed” policies designed to address the consequences of consumer ignorance and irrationality.⁸⁹

This view of consumers, and the policy recommendations that follow, are in turn based on the “behavioral law and economics” literature.⁹⁰ This literature consists of a number of studies in economics and psychology that find that consumers appear to make various systematic mistakes evaluating probabilities and discounting future values, and, further, that consumers make various choices that appear inconsistent with each other.

Members of the behavioral law and economics school typically believe that these studies provide a basis for government interventions in the market to prevent consumers from harming themselves. Some members advocate “soft paternalism” that ‘nudges’ consumers towards what certain scholars deem to be better choices.⁹¹ Such ‘nudges’ often take the form of default rules which map onto the policy preferences of the academic advocate. Professors Cass Sunstein and Richard Thaler, for example, have advocated that businesses make 401-(k) plans “opt out” to nudge consumers to invest in these plans and thereby overcome what Sunstein and Thaler perceive as a tendency to irrationally overemphasize current consumption over long-term saving.

⁸⁷ Bar-Gill & Warren, *supra* note 80, at 21.

⁸⁸ *Id.* at 26.

⁸⁹ See generally Barr et al., *supra* note 844, at 1.

⁹⁰ For a summary of this literature, see Christine Jolls, *Behavioral Law and Economics*, ECONOMIC INSTITUTIONS AND BEHAVIORAL ECONOMICS (Peter Diamond ed., Princeton University Press 2007), available at http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=959177; Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

⁹¹ See Richard Thaler & Cass Sunstein, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (Yale University Press 2008).

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Other behavioral law and economics scholars advocate “hard paternalism” that renders disfavored choices impractical or illegal, even between willing and informed consumers and providers.⁹² “Hard paternalism” includes recently proposed “sin” or “vice” taxes aimed at reducing the consumption of junk food, soda, and cigarettes.⁹³

Behavioral law and economics scholars favoring both “soft” and “hard” forms of paternalism, usually take a dim view of consumer borrowing. They believe that consumers systematically over-value current consumption and do not adequately account for the costs of repayment in the future.⁹⁴ Some members of this school therefore advocate a variety of prohibitions on consumer lending, including banning subprime mortgages;⁹⁵ prohibiting credit cards;⁹⁶ applying state usury laws to credit cards;⁹⁷ and requiring the unbundling of transacting and financing services offered by credit card companies so that consumers could not use the same card to make a purchase and then finance it.⁹⁸

Economists generally agree that consumers do not carry out the perfectly rational computations that theoretical models usually assume. However, there is considerable controversy over whether many of the findings relied on by behavioral law and economics scholars are sufficiently reliable for the purpose of fashioning policy recommendations. Many of the findings are based on laboratory experiments in which students or other test subjects are asked to complete some hypothetical exercise. Economists have found that some of these findings are simply the artifact of how questions are posed to the test subjects,⁹⁹ while

⁹² See, e.g., Bar-Gill & Warren, *supra* note 80, at 21; Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 230-32 (1998); Orly Lobel & On Amir, *Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy* (reviewing THALER & SUNSTEIN, *supra* note 91); Jonathan Gruber, *Smoking's 'Internalities'*, 25 REGULATION 52 (2002-2003).

⁹³ See Gruber, *supra* note 92.

⁹⁴ See Bar-Gill, *supra* note 82, at 1395-1404.

⁹⁵ See generally Alan M. White, *The Case for Banning Subprime Mortgages*, 77 U. CIN. L. REV. 617 (2008) (expounding upon banning several “subprime” lending practices because, amongst other grounds, consumers systematically over-value present-day consumption to future detriment).

⁹⁶ See, e.g., George Loewenstein & Ted O’Donoghue, *We Can Do This the Easy Way or the Hard Way: Negative Emotions, Self-Regulation, and the Law*, 73 U. CHI. L. REV. 183, 204 (2006) (advocating a ban on credit cards).

⁹⁷ *Id.* at 1426-28.

⁹⁸ *Id.*

⁹⁹ Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay-Willingness*

others have argued that the authors of these studies have not adequately explored whether there is a rational explanation for their findings.¹⁰⁰ As Professor David Levine of the California Institute of Technology has observed, “While behavioral economics points to many paradoxes and problems with mainstream economics, their own models and claims are often not subject to a great deal of scrutiny.”¹⁰¹

Although we believe that regulators and policymakers should be aware of some of these new behavioral studies, and may even find useful insights from them, there is hardly a consensus among economists that these studies or their findings are sufficiently robust or accepted to provide the basis for regulators to substitute their judgments for consumers.¹⁰² Unfortunately, many of the behavioral law and economics

to Accept Gap, the “Endowment Effect,” Subject Misconceptions and Experimental Procedures for Eliciting Valuations, 95 AM. ECON. REV. 530 (2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=615861 (“The primary conclusion derived from the data reported here is that observed WTP-WTA gaps do not reflect a fundamental feature of human preferences. That is, endowment effect theory does not seem to explain observed gaps. In addition, our results suggest that observed gaps should not be interpreted as support for prospect theory”).

¹⁰⁰ David Levine, *Is Behavioral Economics Doomed: The Ordinary Versus the Extraordinary*, Max Weber Lecture (June 8, 2009), available at <http://www.dklevine.com/papers/behavioral-doomed.pdf>. See also John List, *Neoclassical Theory Versus Prospect Theory: Evidence from the Marketplace*, 72 ECONOMETRICA 615 (2004) (arguing that laboratory results are not robust to market interactions where competition, expertise, and learning might be expected to ameliorate these biases); John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q. J. ECON. 41 (2003), <http://www.nber.org/~rosenbla/econ311/syllabus/listendowmenteffect.pdf> (arguing the same); Michael S. Haigh & John A. List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. FIN. 523 (2005) (arguing the same); John A. List & Uri Gneezy, *Putting Behavioral Economics to Work: Testing for Gift Exchange in Labor Markets Using Field Experiments*, 74 ECONOMETRICA 5 (2006), <http://rady.ucsd.edu/faculty/directory/gneezy/docs/behavioral-economics.pdf> (arguing the same); Plott & Zeiler, *supra* note 10099, at 1 (finding that the existence and magnitude of the “endowment effect” to be a function of experimental procedures and subject misconception rather than individual preferences); Elizabeth Hoffman, Kevin McCabe, Keith Shachat & Vernon Smith, *Preferences, Property Rights, and Anonymity in Bargaining Games*, 7 GAMES AND ECON. BEHAV. 346 (1992), available at <http://www.neuroeconomics.net/article.php/433.html> (arguing that experimental results themselves are the product of experimental procedures and subject misconception rather than individual preferences).

¹⁰¹ See Levine, *supra* note 101, at 10.

¹⁰² *Id.*

scholars, including the developers of the CFPA, have leapt from a limited and controversial set of academic studies to radical proposals in which the government substitutes consumer decisions with its own preferences. As Professor Jeffrey Rachlinski of Cornell University School of Law notes, “virtually every scholar who has written on the application of psychological research on judgment and choice to law has concluded that cognitive psychology supports institutional constraint on individual choice.”¹⁰³

In concluding that regulators can (and would) make better choices than consumers, behavioral law and economics proponents tend to forget that regulators are human and subject to some of the same “cognitive biases” as everyday consumers.¹⁰⁴ Judge Richard Posner, among other critics, has argued that because regulators are just as likely to suffer from cognitive biases as consumers, regulatory ‘nudges’ have significant potential to do more harm than good.¹⁰⁵ Regulators are, moreover, typically insulated from the incentives to mitigate these errors through education or other means that private actors face in competitive markets.

The CFPA Act is predicated on the view that consumers frequently make irrational decisions especially when it comes to financial products and that the government would make better decisions for consumers and should establish a “supernanny” to protect consumers from themselves. These advocates have not made an adequate case for this radical approach to government intervention in the market.

There is a further concern. The legal scholars who have proposed and designed the CFPA follow in the tradition of the 19th century moralists who believed that credit was the “great tempter.”¹⁰⁶ These scholars believe that borrowing money imposes great costs on consumers without providing sufficient concomitant benefits. Therefore, these scholars favor regulations that sharply constrain the ability of consumers to borrow money.

¹⁰³ Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1166 (2003).

¹⁰⁴ Most of the experimental evidence that shows “irrational” behavior has been conducted with college and graduate students and is perhaps more representative of the college-educated people who work at regulatory agencies than the average American who borrows money.

¹⁰⁵ Richard Posner, *Treating Financial Consumers as Consenting Adults*, WALL ST. J., July 22, 2009, available at <http://online.wsj.com/article/SB10001424052970203946904574302213213148166.html>.

¹⁰⁶ BACHELLER, *supra* note 22, at 116.

They also share the hubris of the 19th century moralists in believing that they are in a better position to make consumer borrowing decisions than the consumers themselves. Irving Bacheller's 1912 screed, *Charge It!*, expounded this philosophy in no uncertain terms. Railing against the "evils of credit," Bacheller argued against one of the financial innovations of the early 20th century — the personal checkbook — which he insisted would tempt consumers to spend too much money.¹⁰⁷

V. Effects of the CFPA Act on Access to Consumer Credit and Economic Performance

The Treasury's CFPA Act of 2009 would likely inflict significant collateral damage on consumers, small businesses and the economy. It would:

- reverse the long-term trend towards the democratization of credit that has especially helped socially and economically disadvantaged individuals;
- reduce the number of jobs created in the economy by making it harder for the new firms that create most jobs to access critical consumer credit; and,
- slow economic growth through reduced consumer spending and job creation.

Under plausible yet conservative assumptions the CFPA could also:

- increase the interest rates consumers pay by 160 basis points;
- reduce consumer borrowing by at least 2.1 percent; and,
- reduce the net new jobs created in the economy by 4.3 percent.

These impacts would lead to a significant long-term drag on economic performance, and simultaneously slow economic recovery.

This section explains the basis for these conclusions. Our analysis proceeds in four steps: Part A provides an overview of the major provisions of the CFPA Act. It shows that the Act would lead to a radical change in consumer protection law in

¹⁰⁷ *Id.*

addition to creating a highly intrusive agency that would impose significant costs on lenders. Part B examines the impact of the provisions of the CFPA on the cost of providing credit and the availability of new and existing lending products. Part B finds that a combination of increased litigation exposure and increased regulatory compliance would likely increase the cost of providing credit products. It could also result in credit products being withdrawn from the market altogether which inherently deters the introduction and advancement of new, innovative products. Part C shows that under plausible assumptions, these increases in costs and restrictions in innovative products could lead to a significant increase in the cost of credit, a reduction in credit availability, and a significant loss of jobs. Lastly, Part D explores the implications of a CFPA-induced credit crunch on the overall economy.

A. Overview of the CFPA Act

There are two broad aspects of the CFPA Act that will affect the lending market. First, the CFPA Act would radically change existing laws on consumer financial protection. Second, the CFPA Act would create a new agency that would have the power to become directly and significantly involved in determining whether, how, and on what terms covered businesses would be able to provide credit to consumers.

i. Legal Changes

The CFPA Act would limit the federal preemption of consumer protection regulation of nationally chartered financial institutions.¹⁰⁸ Specifically, the CFPA Act allows states and municipalities to adopt more stringent regulations than those adopted by the CFPA.¹⁰⁹ Rather than providing a uniform set of regulations governing financial consumer protection, the CFPA effectively provides a “floor” on regulation, exposing banks to substantial compliance costs.¹¹⁰ The Treasury Department’s *Financial Regulatory Reform* plan seems to suggest even further that the CFPA would actively encourage state and local

¹⁰⁸ CFPA Act, *supra* note 1, at § 1041(a)(1).

¹⁰⁹ *Id.* at § 1041(b).

¹¹⁰ *Id.* The CFPA Act also provides for consultation between the proposed Agency and state Attorneys General for potential simultaneous suits under the CFPA Act and more stringent state law. *Id.* at § 1042(b).

enforcement actions.¹¹¹ Consumer protection requirements for lending products could therefore vary across states and possibly municipalities.¹¹² Moreover, historically the FTC has imposed important restraints on the judicial interpretation of state consumer protection legislation, encouraging uniformity among states and consistency with federal consumer protection regulation as well as reducing the possibility of interpretations that are not in consumers' best interests. The CFPA Act would limit those constraints and thereby permit a greater degree of variety and inconsistency in regulations.¹¹³

The CFPA Act would also *change* consumer protection laws as applied to financial products. The new agency is authorized to take action to "prevent a person from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service."¹¹⁴ The new agency is not required to define which practices are "unfair" or "deceptive" in a manner that comports with longstanding and continually developing jurisprudence guided by the Federal Trade Commission under Section 5 of the FTC Act.¹¹⁵ Moreover, the term "abusive" is new to the federal and state consumer protection landscape and thus the CFPA Act of 2009 creates a new legal theory under which lending practices can be found unlawful if deemed "abusive" to consumers.¹¹⁶ Further, while the

¹¹¹ New Foundation, *supra* note 1, at 50-51.

¹¹² CFPA Act, *supra* note 1, at § 1041(b).

¹¹³ See Henry Butler & Jason Johnson, *Consumer Harm Acts? An Economic Analysis of State Consumer Protection Acts* (Northwestern Law & Economics Research Working Paper, No. 08-02, Apr. 24, 2008), available at <http://ssrn.com/abstract=1125305>.

¹¹⁴ CFPA Act, *supra* note 1, at § 1031.

¹¹⁵ *Id.* at § 1031(c). Specifically, the proposed Agency merely needs to "consider established public policies as evidence to be considered with all other evidence" in concluding whether or not a given business practice is "unfair" under the CFPA Act. *Id.* At least one Federal Trade Commissioner has expressed concerns about this feature of the CFPA. See William E. Kovacic, Commissioner, Federal Trade Commission, Statement on the Proposal to Create a Consumer Financial Protection Agency to the Committee on Energy and Commerce and the Committee on Financial Services (July 28, 2009), available at <http://www.ftc.gov/speeches/kovacic/090728stmtrecord.pdf>. Commissioner Kovacic notes that "conflicts in interpretation and in litigation strategies, along with an increase in litigation over jurisdictional questions, will adversely affect every core area of consumer protection for which the FTC will continue to exercise primary responsibility."

¹¹⁶ CFPA Act, *supra* note 1, at § 1031.

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CFPA's ability to declare a practice "unfair" requires at least a superficial analysis of its costs and benefits, no such requirement exists with respect to its powers to identify and impose sanctions against practices it deems "abusive."¹¹⁷ The CFPA Act also provides for a new "reasonableness" standard under which lenders could be liable if they have not provided "reasonable" disclosures to consumers.¹¹⁸

The combination of creating a floor for state and municipal regulation, adding the abusive practices and reasonableness standard, and reopening the interpretation of unfair and deceptive practices is a toxic brew. Such changes would likely subject lenders to regulations that vary across geographic lines, thereby fostering uncertainty over how diverse federal, state, and municipal regulators, and ultimately, the courts will define unfair, deceptive, abusive, and reasonable practices. We return to the cost implications of these legal changes below.

ii. The New Agency

As discussed above, the CFPA would have the ability to impose administrative fines and other sanctions based on its interpretation of what constitutes "unfair, deceptive or abusive" practices and whether lenders have acted reasonably. Within this legal framework, the proposed CFPA would have far-reaching authority to ban consumer lending products, to require lenders to offer products designed by the CFPA, and to require extensive disclosures.

Banning products. The CFPA would have the authority to restrict or ban consumer lending products.¹¹⁹ Given the express disapproval of the proponents of the CFPA of widely used lending products such as subprime mortgages and credit cards, the CFPA would likely use its authority to prevent consumers from obtaining access to products that the consumers want but that the CFPA subjectively believes are bad for them. Professor Barr and his co-authors, for example, have suggested that the government should "specify terms and conditions that are 'safe' and qualify for being offered as a standard credit card." At the same time, they argue for restricting consumer access to credit

¹¹⁷ *Id.* at § 1031(c).

¹¹⁸ *Id.* at §§ 1041(a)(1)-(a)(2).

¹¹⁹ *Id.* at §§ 1031, 1037.

cards that do not meet the government-imposed requirements, and for “increased liability risk if the disclosure is found to have been unreasonable” after the fact.¹²⁰

Mandated provision of “plain vanilla products”. Under the Administration’s plan, the CFPA could consider requiring lenders to make “plain vanilla” products of the CFPA’s design available to the consumer.¹²¹ The agency could insist that consumers explicitly reject the “plain vanilla” product before the lender could offer its own product.¹²²

Regulatory review of new products. The CFPA could subject new products to an extensive review process, including one in which the CFPA must approve mandatory disclosure language for the product.¹²³ The CFPA could also require firms to provide detailed information on consumer choices, including “warnings to consumers about the heightened risks” of using alternative products not pre-approved by the CFPA.¹²⁴

B. Effect of the CFPA Act on the Cost of Providing Credit and the Availability of Consumer Lending Products

i. Impact of Costs

These provisions of the CFPA would likely raise the cost of providing credit significantly. We begin with the legal changes. To begin, it is important to recognize that any new regulation, no matter how simple or well intended, can result in (or add to) a mass of conflicting interpretations and litigation, the net result of which is higher costs and greater uncertainty for covered businesses. The Truth in Lending Act provides a good example.¹²⁵ A week before the law became effective in 1969 there were 34 official interpretations of the regulation. Ten years later, federal courts were inundated with more than 13,000 Truth-in-Lending lawsuits. By early 1980, the Federal Reserve Board had

¹²⁰ Barr et al., *supra* note 84, at 15.

¹²¹ CFPA Act, *supra* note 1, at § 1036(b)(1).

¹²² *Id.* at §§ 1036(b)(1)(B); 1036(b)(2).

¹²³ *Id.* at §§ 1032(a); 1034(a), (b).

¹²⁴ *Id.* at § 1036(b)(1)(A).

¹²⁵ See Thomas A. Durkin, *The Impact of the Consumer Financial Protection Agency Act on Small Business*, US CHAMBER OF COMMERCE MAGAZINE, Sept. 23, 2009, available at http://www.uschambermagazine.com/publications/reports/090923_cfpa_sb.htm (last visited Feb. 10, 2010).

published more than 1,500 interpretations attempting to provide some clarity to minimize the uncertainty created by the varying decisions made by the courts. Today, compliance with the Truth-in-Lending law requires a great deal of resources. The CFPA Act is likely to lead to a bureaucratic and legal mess far greater than the Truth-in-Lending Law generated. That is because the CFPA Act is a much more expansive and far-reaching piece of legislation, and, most importantly, unlike the Truth-in-Lending law, the CFPA Act provides for the states and municipalities to have their own laws and regulations which will also require interpretation.

The CFPA Act would also result in financial institutions facing significant legal costs for lawsuits emanating from states and localities. To begin with, the states could sue lenders under Section 1031 of the CFPA Act which prohibits “unfair,” “deceptive,” or “abusive” lending practices.¹²⁶ Other industries that have been exposed to state litigation have incurred significant costs as a result, which they have had to pass on to consumers.¹²⁷ Consumers of pharmaceutical products have incurred costs in the tens of billions of dollars as a result of state product liability litigation according to one study.¹²⁸

Lenders would also face significant costs in the form of hesitant reactions in the face of considerable uncertainty. It could take years for lenders to fully understand how the courts will ultimately define unfair, deceptive, and abusive practices; and what constitutes a reasonable disclosure of information. During

¹²⁶ CFPA Act, *supra* note 1, at § 1031.

¹²⁷ See Professor Michael J. Saks’ letter to Sen. Ernest Hollings, S. 687. The Product Liability Fairness Act: Hearing Before the Subcommittee on Consumer of the Committee on Commerce, Science, and Transportation, United State Senate, One Hundred Third Congress, first session, September 23, 1993, 126. Even though the average price effect of liability costs may be small across industries, in some sectors it can be quite large. See Tomas J. Philipson & Eric Sun, *Is the Food and Drug Administration Safe and Effective?*, 22 J. ECON. PERSP. 85, 94–95 (2008) (suggesting that the deadweight losses to consumers and producers from the price increase due to product liability litigation in the pharmaceutical industry is in the tens of billions of dollars); Paul Rubin & Joanna Shepherd, *Tort Reform and Accidental Deaths*, 50 J.L. & ECON. 221 (2007) (estimating that product liability has increased accidental deaths by raising the prices of safety-enhancing goods and services); Richard L. Manning, *Changing Rules in Tort Law and the Market for Childhood Vaccines*, 37 J. L. & ECON. 247, 273 (1994) (suggesting that the price of vaccines went up twenty-fold after product liability imposed).

¹²⁸ See Philipson & Sun, *supra* note 128.

this period, lenders would have difficulty assessing what they are required to do under the new law or what their financial exposure would be for failing to meet legal requirements across diverse geographic lines. In addition, the exposure to state and local litigation would pose the possibility that financial institutions would face penalties that could lead to severe losses or even bankruptcy. Businesses, of course, must be compensated for bearing risk and uncertainty.

As noted above, the CFPB Act simultaneously opens consumer financial protection to diverse and inconsistent state and local regulation, allows regulators to adopt new interpretations of traditional consumer protection terms such as unfair and deceptive practices, and adds new concepts of abuse and reasonableness which are undefined in the consumer credit context. These three features have a multiplier effect and would likely result in exponential increases in the cost and uncertainty of complying with consumer financial protection laws and regulations.

In addition to these changes in the legal landscape and governance of financial institutions, the CFPB Act would likely also impose other significant costs on consumer lending products and providers of those products. Each new loan would require additional paperwork and other compliance costs. This increase in paperwork is not merely speculative. According to the Act, "The Agency may on a periodic basis . . . require reports from a covered person for purposes of ensuring compliance with the requirements of this title, the enumerated consumer protection laws, and any rules prescribed by the Agency. . ."¹²⁹ In granting the proposed Agency broad powers to create rules, this provision single-handedly allows for potentially unlimited reporting on an undefined amount of unwritten administrative regulations.

The intensive review process envisioned by the CFPB Act would be particularly expensive for new products.¹³⁰ Firms introducing new products often make numerous subsequent adjustments in their designs in response to feedback from consumers and as they learn about the performance of those products and consumer preferences. Providers of new consumer financial products would have to submit these products to the CFPB's review process before they have gotten any market feedback and, in effect, before these products were "fully baked."

¹²⁹ CFPB Act, *supra* note 1, at § 1022(c)(1).

¹³⁰ *Id.* at § 1036(b)(1).

Normal changes in product design following the introduction of the lending product could expose the firm to administrative or enforcement actions unless submitted to the CFPB beforehand for further review and approval, exponentially delaying a firm's ability to offer consumers improved products. The lack of consumer experience is also a problem for the agency which would be making judgments on disclosure and other issues with at best limited information from consumers. As Federal Trade Commissioner Thomas J. Rosch has noted, "there is no evidence that this proposed new agency has any core competency in protecting consumers in the financial marketplace."¹³¹ It is therefore likely that the CFPB Act's "plain vanilla" requirements would induce consumers to take products that would be inferior to those the consumers would have chosen on their own.¹³² The CFPB Act would therefore likely impose a significant increase in the costs and risks of introducing new products.

The "plain vanilla" requirement is likely to impose even further costs and risks on lenders. Consider a lender that introduces a new lending product. The lender determines whether the introduction of that product will generate enough profit to justify its investment in the product along with its exposure to litigation and regulatory costs. Suppose the lender determines that, before taking into account the effect of the "plain vanilla" requirement, it would be profitable to make a particular product available to consumers. Now the lender must factor in the CFPB's decisions on a "plain vanilla" product. Some, and perhaps many, consumers may decide to take the "plain vanilla" version. That version may be less profitable than the version designed by the lender. As a result, the new product may not yield an adequate return when the profits from both the product designed by the lender and the "plain vanilla" product designed

¹³¹ J. Thomas Rosch, Commissioner, Fed. Trade Comm'n, Statement on the Proposal to Create a Consumer Financial Protection Agency Before the Committee on Financial Services (July 21, 2009), *available at* <http://www.ftc.gov/speeches/rosch/090721roschstatement.pdf>.

¹³² The CFPB Act requires the new agency to subject its rules and regulations to a cost-benefit test. Other federal agencies have the same requirement yet there is little evidence that it is taken seriously. *See generally* Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. Rev. 1489 (2002); Moreover, the proponents of the agency tend to see more costs than benefits associated with consumer borrowing which suggest that the new agency, if it adopted a similar view, would find that restrictions on consumer credit availability pass a cost-benefit test.

by the CFPA are taken into account. Alternatively, the lender may have to raise fees on both the “plain vanilla” product and its own product to cover revenue losses associated with the diversion of customers from its own product to the “plain vanilla” product. Finally, in any event, the lender would need to factor in the risks associated with the CFPA’s decisions on how to design a plain vanilla product when making decisions on investment in a new lending product. To compensate for that added risk, the lender would have to increase the interest rates and fees for new products that it introduces.

Overall, the CFPA Act would likely increase the costs of supplying credit to consumers. The variable cost of lending would increase as a result of both the paperwork requirements and the increased litigation exposure that each loan presents. This would increase interest rates and other fees associated with extending a loan. In addition, the CFPA Act would increase the fixed costs of making a particular lending product available to consumers. New products in particular would face a lengthy and more involved review process, therefore requiring the development of disclosures that meet the agency’s reasonableness requirement and could satisfy its unfair, deceptive, and abusive practices requirements.

Lenders offering new and innovative products could also face financial exposure from litigation over the provision of such products. As a result, lenders would have to raise the interest rates and fees on products to cover these costs or, alternatively, not make those products available at all.

ii. Impact on the Availability of Consumer Lending Products

We have just seen that the CFPA Act would likely increase the prices that consumers pay for credit products. Consumers are actually harmed in two ways. First, higher prices directly curtail the amount of credit available to consumers; consumers will become worse off because they no longer get to enjoy the benefits of that credit. For the credit that consumers still obtain, they would pay higher prices and have less money to spend on other things. As we explain in the next section, these changes in prices and consumption are likely to be very costly.

The second and more serious concern with the CFPA Act is that it would prevent consumers from obtaining certain credit products at all. As a result, consumers would lose the entire benefit they were previously obtaining from those products. In

extreme cases, consumers may have no other lending product to turn to and would be liquidity constrained. There are two reasons to believe that the CFPB Act would completely destroy consumer access to certain credit products and, in some instances, credit altogether. The first follows directly from the preceding discussion: lenders would discontinue the production of lending products that would no longer be profitable as a result of the increased costs imposed under the CFPB Act regulatory regime. Here, we focus on the second reason: the CFPB itself is likely to directly prevent consumers from obtaining lending products that they would like to use.

The CFPB would have the authority to ban or restrict certain lending products.¹³³ Of course, the likelihood that the new agency would ban various consumer lending products that consumers would use if they were available does not by itself mean that consumers would be harmed. The well-meaning scholars who have designed the CFPB Act believe that they have provided theoretical and empirical evidence which demonstrates that various lending products, or significant variants of these products, harm consumers. They believe that many consumers use these products because they are misinformed and irrational. This view is misguided for at least two reasons.

First, as we described in Section II, consumers borrow money for sound and rational reasons. Consumers can improve their level of well-being by borrowing against future income that so that their enjoyment of life is not unnecessarily concentrated in middle age. Consumers also benefit from borrowing for many other reasons: a temporary short-fall of income, sudden expenses, entrepreneurial ventures, or a desire to make long-term investments. In short, the fact that consumer behavior does not conform to paternalist advocates' subjective valuation of future time or income does not *ipso facto* render consumer choices irrational or welfare-reducing. Indeed, the burden is on those who would deny consumer's own evaluation of their welfare to prove that consumers are wrong, and that the CFPB would consistently make better judgments the gains from which exceed the costs the CFPB imposes on lenders and borrowers.

Second, consumers are necessarily in a better position than regulators to decide which products are most beneficial to them given their particular circumstances. Individuals know their own preferences, such as their personal tradeoffs between risk and

¹³³ CFPB Act, *supra* note 1, at §§ 1036(b)(1), 1039.

certainty, or between consumption and debt. Consumers also have more knowledge of their own aspirations, needs, future incomes, and other life plans than regulators could ever have. We are highly skeptical that regulators could better assess which lending products should be offered to consumers than those same lenders who have a direct competitive interest in satisfying consumers' needs and tastes.

Professors Bar-Gill and Warren argue that regulators should prevent the sale of harmful consumer lending products in the same way they prevent the sale of exploding toasters. The analogy is inapt and, more importantly, does not reflect the type of consumer lending regulation that these designers of the CFPA have in mind. Consumers do *not* want to buy toasters that have a significant risk of explosion and they can directly benefit from government regulations that require manufacturers to make toasters safe. Consumers *do* want to borrow money even though there is a risk that they will have trouble paying it back or that the house they bought might not appreciate as much as they had hoped. Consumers knowingly choose to take these risks all the time. The advocates of the CFPA Act are *not* seeking to prevent lenders from offering consumers the credit equivalent of an exploding toaster. Rather, the CFPA Act's advocates believe that consumers should be restrained from choosing products and services that significant numbers of consumers have willingly used safely, to their advantage personally, and to the great benefit of society as a whole. The CFPA Act's advocates would have consumers "nudged" into using only those particular products that the regulators have approved for them. This approach to regulation would be like having the Consumer Product Safety Commission prohibit the sale of particular toasters that they believe consumers do not really need, or requiring toaster manufacturers to offer consumers a "plain vanilla" toaster in addition to, and even in preference to, their feature-laden models.

We showed earlier that financial innovation expanded the supply and accessibility of consumer credit enormously between the start of the 1980s and the onset of the current financial crisis. During that period of time, innovations in risk analysis and securitization, combined with the introduction of many new credit products, enabled millions of Americans to borrow. Millions were able to buy homes, which, for the vast majority, were good investments. Americans were able to borrow against future income to buy many common consumer durables- everything from automobiles to refrigerators to televisions- that

households buy especially when they are younger.

The financial innovations helped American consumers weather some stormy economic times, including the period of high interest rates and inflation uncertainty in the late 1970s and early 1980s, the stock market crash of 1987, and the collapse of the dot.com bubble and the uncertainty following 9/11. Innovative consumer lending products also helped accommodate a massive increase in household formation as a result of the baby boom generation—and their children—entering the workforce.

These financial innovations also relieved the liquidity constraints that prevented many socially and economically disadvantaged Americans from gaining access to credit. As a result, more minorities, single parents, and low-income households were able to get mortgages, credit cards, and other lending products that markedly improved their lives. Furthermore, financial institutions were able to lend money to more high-risk households because these institutions had tools that enabled them to better identify and manage the risks; and because these lenders could diversify their risks through securitization and other risk management tools.

Based on our analysis of the CFPA Act and how its proponents envisaged the CFPA Act to regulate consumer financial products, we believe that the most likely scenario is that, if enacted, the CFPA Act would reverse the increase in the availability and democratization of credit that consumers have benefited from over the last thirty years. The CFPA Act would result in a credit crunch for many Americans who would either not have access to credit or have to turn to inferior sources of credit such as pawn shops and payday lending.

C. The Estimated Effects of the CFPA Act on Economic Welfare¹³⁴

The CFPA Act will impose a significant cost shock to

¹³⁴ Professor Adam Levitin argues that these estimates are speculative; see Adam Levitin, *A Critique of Evans and Wright's Study of the Consumer Financial Protection Agency Act 1* (Georgetown University Law Center, Public Law Research Paper No. 1492471, Oct. 22, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1492471. We disagree with his comments as discussed in David S. Evans and Joshua D. Wright, *A Response to Professor Levitin on the Effects of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit* (George Mason Law and Economics Research Paper No. 09-56, Nov. 3, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1499261.

lenders. One way to understand the possible impact of the Treasury's CFPB Act is to examine other shocks to the lending industry. A major part of our concern with the CFPB Act's impact on lending costs is that the Act will result in significant state-by-state variation in regulation, which will undoubtedly impose increased transaction costs on lenders. One might immediately intuit that the greater the variation amongst states, the greater these costs will necessarily be. The 1994 Interstate Banking and Branching Efficiency Act (IBBEA) is one such shock that provides empirical data by which one can assess the CFPB Act's possible effect. The IBBEA allowed bank and bank holding companies to expand across state lines; prior to its passage there had been virtually no interstate branches. The IBBEA, however, preserved states' rights to impose various costs on the expansion of out-of-state banks in their states; many states exercised this right. Thus, the "IBBEA shock" did precisely what the proposed CFPB Act will do: it ended federal preemption, causing a proliferation of divergent state laws impacting lending costs.

Rice and Strahan examine the impact of the IBBEA on the interest rates paid by small firms.¹³⁵ By comparing bank lending in states that imposed restrictions with those that did not, Rice and Strahan were able to estimate the effect of these state-imposed restrictions on the interest rates paid on bank loans by small businesses. They found that the interest rates paid by small businesses were 80 to 100 basis points higher in states with the most restrictive rules on bank expansion compared with the states with the least restrictive rules.

We take the conservative 80 basis point regulatory penalty as a lower bound on the effect the CFPB Act would have on interest rates. The regulatory restrictions imposed by the states following the IBBEA were relatively modest and require little in the way of judicial interpretation. They included setting a minimum age of the target institution, restrictions on acquiring individual branches, imposing a statewide deposit cap, and preventing, in some cases, setting up a new branch. The scope of the CFPB Act is enormous in comparison. It would constitute a highly intrusive federal regulatory agency, require lenders to comply with differing regulations across 50 states and their

¹³⁵ Tara Rice & Philip E. Strahan, *Does Credit Competition Affect Small Firm Finance?* (2009), available at http://www2.bc.edu/~strahan/CreditCompetition_June2009.pdf.

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component municipalities, create a costly product review process, and expose lenders to litigation under untested laws by federal, state, and municipal enforcers.

Furthermore, there is also an enormous difference in the degree of uncertainty that banks would face. The restrictions that banks faced in some states following the IBBEA were clear and known with certainty; there was a precise age requirement or deposit cap imposed by a state. These restrictions did not impose significant costs on banks deriving from uncertainty with regard to how the restrictions would be interpreted and change over time. The CFPA Act, on the other hand, creates considerable uncertainty because many of the federal and state rules concerning what lenders can and cannot do are vague and ambiguous. The application of the “unfair,” “deceptive,” “abusive,” and “unreasonableness” standards by the regulators and courts will remain highly uncertain for many years.¹³⁶

It is therefore plausible that the CFPA Act would impose a multiple of the costs on lenders than what the states imposed through geographic branching restrictions following the passage of the IBBEA. We report estimates based on the CFPA Act having the same, twice, and three times the impact on interest rates as the state-imposed geographic branch restrictions studied by Rice and Strahan. Those estimates imply that the CFPA Act would increase interest rates by 80 basis points if the impact of the CFPA Act’s regulations was the same as the geographic restrictions, 160 basis points if the impact of those regulations was twice as costly, and 320 basis points if it was three times as costly. We take 160 basis points as the likely lower bound on the effect of the CFPA Act on interest rates.

Consumers would not just pay more for credit. In response to the increased prices, consumers would use less credit, with a resulting impact on consumer spending. Financial economists have also used changes in nominal credit card interest rates to estimate long-run debt elasticity in consumer credit markets of -

¹³⁶ For an illustrative example, state Consumer Protection Acts (CPAs) modeled on the Federal Trade Commission Act’s prohibitions of “unfair” and “deceptive” business practices have resulted in significant variation in substantive consumer protection regulation and remedies between states, with that variation creating significant uncertainty and litigation. *See* Searle Civil Justice Institute, *State Consumer Protection Acts: An Empirical Investigation of Private Litigation* (November 2009), *available at* http://www.law.northwestern.edu/searlecenter/uploads/CPA_Proof_113009_final.pdf.

1.3.¹³⁷ That is, a 1 percent (a 100 basis point) increase in the cost of debt would reduce the amount of long-run debt acquired by 1.3 percent. Combining these estimates, we can generate a rough prediction of the impact of the CFPB on interest rates and credit supply assuming that the regulatory costs would generate interest rate effects that are equal to, twice as bad, and three times as bad as the state restrictions on interstate banking. An 80 basis point increase would result in a 1.0 percent reduction in amount of long-term debt, a 160 basis point increase would result 2.1 percent reduction in the amount of long-term debt, and a 320 basis point increase would result in a 4.2 percent reduction in the amount of long-term debt. These estimates should be interpreted as lower bounds on consumer responsiveness to changes in interest rates since they are calculated with data from the 1990s and, at the current dramatically reduced levels of consumer credit available after the financial crisis, more consumers are liquidity constrained and thus more sensitive to interest rate changes. We take 2.1 percent as the likely lower bound on the reduction in credit borrowing for these reasons but also because the CFPB Act may also ban certain lending products that are the only way for some consumers to borrow.

The reduction in credit availability would be likely to generate significant losses for consumers. The economic literature provides some estimates of the effects of regulatory restrictions on access to credit products likely to fall under the CFPB's scope. For example, Morse finds that restrictions on financial products can exacerbate the negative impact of disasters, including 1.2 more foreclosures per 1,000 homes and 2.67 more larcenies per 1,000 homes.¹³⁸ This analysis suggests that the harmful consequences of restrictions on lending products will be felt not only by consumers facing personal emergencies, but also by communities that are left less able to rebound quickly from community shocks. Federal Reserve economists Morgan and Strain reach similar results, finding that restrictions on consumer financial products in Georgia and North Carolina resulted in more bounced checks, more complaints about lenders and debt

¹³⁷ David Gross & Nicholas Souleles, *Consumer Response to Changes in Credit Supply: Evidence from Credit Card Data* (Wharton Business School, Working Paper, Feb. 4, 2000), available at <http://knowledge.wharton.upenn.edu/papers/1161.pdf>. These estimates are based on credit cards and could be different for other debt products.

¹³⁸ Adair Morse, *Payday Lenders: Heroes or Villains?* (Booth School of Business, Working Paper, Jan. 2009).

collectors filed with the Federal Trade Commission, and more bankruptcies.¹³⁹ Similarly, Karlan and Zinman find that access to consumer financial products can significantly improve household outcomes ranging from job retention to staving off hunger.¹⁴⁰

The CFPA Act credit squeeze is likely to negatively impact small businesses and job creation.¹⁴¹ Small businesses can have a difficult time obtaining credit because they present lenders with significant adverse selection, moral hazard, and asymmetric information problems – not to mention high failure rates. Indeed, one estimate suggests that approximately 20% of firms with fewer than 20 employees did not bother to apply for credit because they assumed they would be denied.

Small businesses necessarily rely extensively on consumer financial products. These include home equity loans, personal loans, auto title loans, and credit cards.¹⁴² Indeed, almost half of firms with fewer than 20 employees use a consumer credit card to help finance their businesses.¹⁴³ These small business owners would encounter the same increase in the cost of credit as regular consumers and face the same prospect of not being able to get credit at all. Since small businesses are notoriously fragile these increases in the cost of credit, or denial of credit, could have far reaching effects on the viability of small firms.

As a result of its impact on small firms that rely on consumer credit, the CFPA Act could have serious effects on job creation. Most net new jobs in the United States are created by new firms, which by-and-large begin small – often as sole proprietorships.¹⁴⁴ These small businesses account for a disproportionate share of new job creation in the United States.¹⁴⁵

¹³⁹ Donald P. Morgan & Michael R. Strain, *Payday Holiday: How Households Fare after Payday Credit Bans* 4-5 (Fed. Reserve Bank of N.Y., Working Paper, Feb. 2008). See also, Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap* 2-5 (2009).

¹⁴⁰ Dean Karlan & Jonathan Zinman, *Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts* (Innovations for Poverty Action, Working Paper, 2008).

¹⁴¹ Durkin, *supra* note 126, at 1.

¹⁴² Charles Ou and Victoria Williams, *Lending to Small Businesses by Financial Institutions in the United States*, SMALL BUSINESSES IN FOCUS: FINANCE, A COMPENDIUM OF RESEARCH BY THE SMALL BUSINESS ADMINISTRATION'S OFFICE OF ADVOCACY, at 9 (2009).

¹⁴³ *Id.*

¹⁴⁴ Net new jobs takes into account the fact that new firms both create jobs and, when they fail, destroy jobs.

¹⁴⁵ John Haltiwanger, Ron Jarmin & Javier Miranda, *Business Formation*

Startup firms with fewer than 20 employees accounted for 86.7% of net job creation in the United States in 2005.¹⁴⁶ As noted above, about half of these businesses relied on credit cards for financing and others rely on other forms of consumer financing.

We believe that it is plausible that the CFPA Act could result in a significant number of aspiring new small business owners not being able to obtain the consumer credit necessary to get their businesses off the ground. An extensive body of economic literature demonstrates that entrepreneurs are liquidity constrained and that lack of access to credit deters many from starting new businesses; the flip side of this finding is that a contraction in the supply of credit increases the number of entrepreneurs that are liquidity constrained and thereby reduces the number of start-ups.¹⁴⁷ Suppose that the increase in credit prices and reductions in the availability of credit results in only a 5 percent reduction in the number of aspiring entrepreneurs were not able to start their firms. If we focus just on firms with fewer than 20 employees, that could lead to the elimination of roughly 4.3 percent ($.05 \times .867$) of net new jobs. We believe that this is a plausible but hardly precise estimate of the order of magnitude that the CFPA Act could have on employment.

D. The CFPA Act of 2009 and the Economic Recovery

The timing of the CFPA Act of 2009 could not be worse. Suppose the Act became law by July 1, 2010. It would take many months, and perhaps years, before the agency envisioned by the CFPA Act would begin functioning. The Administration would have to make a number of appointments, the existing regulatory agencies would have to transfer staff, and the new agency would

and Dynamics by Business Age: Results from the New Business Dynamics Statistics, (2008), available at http://econweb.umd.edu/~haltiwan/bds_paper_CAED_may2008_may20.pdf.

¹⁴⁶ In 2005, net job creation at new firms with less than 20 employees was 2,151,513 while total net job creation across all firms was 2,481,097. See U.S. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Firm Age By Firm Size, available at http://www.ces.census.gov/index.php/bds/bds_database_list. Over the period 1987-2005, the net new jobs (taking jobs created minus jobs lost) by new firms with less than 20 employees exceed overall total net new jobs because many older and larger firms had net job destruction.

¹⁴⁷ See David S. Evans & Boyan Jovanovic, *An Estimated Model of Entrepreneurial Choice under Liquidity Constraints*, 97 J. POL. ECON. 808, 808-27 (1989).

have to organize itself and hire additional staff to meet its new responsibilities. It would then take further time before the new agency would have the opportunity to interpret its legislative mandate and adopt rules and regulations. It would also take time before the courts had reviewed cases to test these interpretations. The severe limitations on federal preemption would also likely lead states and municipalities—who would not be required to wait for the CFPA to get organized and become fully operational—to adopt new and likely conflicting consumer lending regulations, creating a stilted, heterogeneous set of legal regimes at the state level.

For a substantial period of time financial institutions would face great uncertainty over the likely costs of lending to consumers for the reasons discussed above; whether their financial products would be approved by the new agency; the nature of the plain vanilla products and the effect of these product on the profitability of lending to consumers; and the scope of their institutions' litigation exposure. We would expect financial institutions to address these major new regulatory risks by reducing their lending to consumers in the face of this uncertainty. In consequence of these limitations on business activity, investors would shy away from placing their capital in firms subject to CFPA Act authority, limiting capital growth if not actually shrinking it.

That reduction in lending would occur almost immediately after the passage of the legislation. It would come at a time when the economy is just beginning a tenuous recovery from the deepest economic downturn in 75 years. A major obstacle to the economic recovery is that lack of access to financing for consumers and businesses. It is well known that many consumers and businesses in today's economic environment have great difficulty obtaining mortgages, educational loans, automobile loans, credit card loans, and other sources of credit. The Federal Reserve reported consumer credit dropped by historic rates in the last weeks of the summer 2009. It decreased from 2.74 trillion in July 2008 to 2.47 trillion in July 2009.¹⁴⁸ Small businesses which rely on consumer lending products to finance their operations have been especially hurt.¹⁴⁹

¹⁴⁸ Federal Reserve Statistical Release G19, Sept. 9, 2009, *available at* <http://www.federalreserve.gov/releases/g19/Current/>.

¹⁴⁹ See, e.g., Joseph A. Mann, Jr., *Lack of Credit Hurts Small Businesses*, MIAMI HERALD, Feb. 25, 2009, *available at* <http://www.miamiherald.com/business/5min/story/914255.html>.

The CFPB Act would deter financial institutions from expanding consumer lending needed for the success of these very businesses.

The ramifications of this reduction in consumer lending in 2010 and 2011 that could occur if the Treasury's CFPB Act of 2009 were signed into law are quite serious. Consumer spending is vital to any economic recovery. Encouraging sustainable consumer spending requires encouraging policies that induce consumers to buy homes and consumer durable goods again as well as to engage in everyday shopping. As is well known, consumer spending has a multiplier effect, which leads to dramatic economic expansion and the growth in jobs. With an unemployment rate of close to 10 percent and weak consumer spending it would seem particularly counterproductive to have the government impede credit availability by raising the costs and risks on consumer lending by financial institutions. It is also not the time to further restrict lending to small businesses and dampen the creation of new jobs that are important for pulling the economy to recovery.

VI. Conclusions

The CFPB Act of 2009 proposed by the U.S. Department of the Treasury is a misguided attempt to erect a supernanny agency that would substitute its own choices for how and under what circumstances consumers should be able to borrow money. The proponents of the CFPB Act have not provided a basis for adopting sweeping changes in the regulatory structure of consumer financial protection regulation. While improving consumer protection is needed, particularly for the non-bank institutions that virtually all commentators identify as the source of most problem mortgages, it is hard to maintain that the financial crisis would have been avoided by more consumer protection.¹⁵⁰

Short-term the CFPB Act would jeopardize the current economic recovery, and recovery from high unemployment, because the Act would significantly raise the uncertainty over the costs of lending consumers money. It would take several years for the new agency to give lending institutions clear guidance and for

¹⁵⁰ FEDERAL RESERVE BOARD, STAFF ANALYSIS OF THE RELATIONSHIP BETWEEN THE CRA AND THE SUBPRIME CRISIS, Nov. 21, 2008, *available at* http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf.

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the courts to interpret new legal obligations on lenders, suppressing lending activity (and investment in lending firms) in the meanwhile.

Over the longer term, the CFPB Act of 2009 would restrict the supply of consumer credit, reduce consumer choice over how consumers can borrow, and increase the cost of consumer credit. In doing so it would inflict collateral damage on small businesses that often rely on consumer credit products. A significant part of these increased costs would come from opening a flood gate of state regulation and litigation under a new vague legal standard. The CFPB Act would also turn back the clock on successful efforts to democratize credit—that is to make credit widely available so that all segments of American consumers can borrow to meet their short-term and long-term needs. It would further make it harder for the new firms that create most jobs to obtain credit and would thereby lead to a permanent reduction in job creation.