Who's Afraid Of Abusive Practices?

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I. Introduction

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") establishes the Consumer Financial Protection Bureau ("the Bureau"). Dodd-Frank defines a broad, bordering on overwhelming, mission for the Bureau. According to the legislation, the Bureau will "implement and, where applicable, enforce federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."[1]

The enabling legislation identifies five objectives for the Bureau:

- provide consumers with "timely and understandable information to make responsible decisions about financial transactions;"
- protect consumers from "unfair, deceptive or abusive acts and practices and from discrimination;"

[1] § 1021(a).

- regularly identify and address outdated, unnecessary, or unduly burdensome regulations in order to reduce unwarranted regulatory burdens;
- consistently enforce federal consumer financial law without regard to whether someone is a depository institution in order to promote fair competition; and
- deliver transparent and efficient operation of markets for consumer financial products and services to facilitate access and innovation.[2]

Dodd-Frank grants the Bureau broad supervisory, enforcement, and rulemaking authorities over an array of entities. The Bureau has authority over any person offering a "consumer financial product or service," and any affiliate of such a person that acts as a service provider to such person.[3] The statute defines "financial products or services" to include virtually the full sweep of financial services (with the significant exception of insurance). The list of services that fall within the Bureau's sweep is long:

- extending credit and servicing loans;
- extending or brokering leases or personal or real property that are the functional equivalent of purchase finance arrangements;
- providing real estate settlement services;
- engaging in deposit-taking activities;
- transmitting or exchanging funds;
- selling or providing stored value or payment instruments;
- providing check-cashing, collection, or guaranty services;

[2] § 1021(b).
[3] § 1002(6).

- providing payments or other financial data processing products or services to a consumer by any technological means;
- providing financial advisory services;
- collecting, analyzing, maintaining, or providing consumer report information or other account information; and
- debt collection.[4]

The Bureau has produced considerable anxiety in the consumer finance industry. Most of the anxiety has focused on two issues—who will head the Bureau and what will the Bureau do with the newly created power to ban "abusive" products. This article suggests that the financial services industry should be focused on a third question—what will the Bureau do with its power to regulate the disclosure of consumer financial services.

II. Dodd-Frank Gives The Consumer Financial Protection Bureau Significant Power To Regulate Disclosures.

As noted, much attention has been paid to the new authority that Dodd-Frank grants to the Bureau to prohibit acts or practices that are "unfair, deceptive, or abusive." Relatively little attention has been given to the Bureau's power to regulate the disclosure of consumer financial products. Yet, the text of the Bureau's enabling legislation provides the Bureau with significant new rulemaking power related to the disclosure of consumer financial products.

[4] § 1002(15).

Dodd-Frank makes the Bureau the principal regulator of the form and content of consumer financial products. It gives the Bureau the authority to require that the features of any consumer financial product or service "are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances."[5] The Bureau's authority begins with the initial and continues "over the term of the product."[6]

As with the much discussed "abusive" power provision, the text of the Dodd-Frank Act leaves open how the Bureau might exercise this disclosure power. The Act puts few constraints on the Bureau's exercise of this power. It instructs the Bureau to consider available evidence about consumer awareness, understanding of, and response to disclosures or communications about the risks, costs, and benefits of consumer financial products or services. In exercising this power, the Bureau could limit it attention to the concerns that prompted the initial passage of the Truth-In-Lending Act in 1968, *i.e.*, the development of a metric and vocabulary for comparing the costs of credit across different types of credit products. Or the Bureau could use its new power to attempt to force providers of consumer financial services to standardize the terms of those products.

The scope of the Bureau's power will likely be defined by how it chooses to answer three questions:

- *Who* must be permitted to understand (*i.e.*, what is the relevant universe of consumers)?

[5] § 1032(a).

[6] *Id.*

- What defines the universe of things that must be understood (or, put slightly differently, how should a consumer financial institution know *what* a consumer must be permitted to understand)?
- What does "permit to understand" mean?

The text of the Dodd-Frank does not answer any of these questions or shed any light on how they should be answered. But answers to these questions will have significant implications for the types of products that financial institutions will be permitted to offer to consumers going forward.

The question of which consumers define the universe of the Bureau's disclosure power is common to a number of legal and regulatory regimes. The common law, for example, famously defines the level of care that people must take to avoid liability for negligence as the "reasonable man" or, more recently, "reasonable person" standard. Per the Second Restatement of Torts, the "reasonable man" standard refers to the behavior of the "ideal person" exercising "average prudence" or "reasonable sense." [7] Other regulatory regimes allow more targeted populations to be identified. Someone seeking to get a pharmaceutical approved by the FDA need not prove that a compound will be safe and effective for all people. Thus, thalidomide has been approved as treatment for people suffering from painful complications of leprosy and other auto-immune disorders but not for women looking for relief from morning sickness.

But the fact that it is a common question does not make it an easy one for the Bureau to answer. On one extreme, the Bureau could require that every consumer understand (however understand is ultimately defined) every consumer financial product.

[7] Restatement (Second) of Torts § 283, comment c (1980)..

On the other hand, it could allow financial institutions to develop disclosures tailored to an idealized composite consumer. This idealized composite could even vary depending on the nature of the product—*e.g.*, one "reasonable person" for payday loans and another for jumbo super-price mortgages.

The answer to the question of *what* precisely consumers (or an hypothesized composite) must understand is not obvious either. As former Federal Reserve economist, Thomas Durkin, recently detailed, this problem has vexed the prior disclosure regime for consumer credit products, the Truth-Lending-Act, since before it was passed. As Durkin explains, TILA was the brainchild of Senator (and one time University of Chicago economics Professor) Paul H. Douglas.[8] When Senator Douglas introduced the first version of TILA, it "consisted of only three and one half pages of large type" and "required only two federal disclosures, total finance charges and 'simple annual interest.'"[9] Even before the passage of the CARD Act, the list of TILA's requirements for just revolving credit had increased by 1500%.[10]

The problem, as Durkin explains, flows from two seeming inextricable aspects of most consumer credit transactions—the divisibility of even the simplest transaction into discrete components and the confounding effect of time. Most revolving credit transactions, for example, involve five parties—a consumer, a merchant, banks for both the consumer and the merchant, and a network connecting the parties. At a minimum, every transaction involving a revolving credit card can be divided into a payment service and a credit service. If a consumer receives a discount in exchange for using a particular

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[8] Thomas A. Durkin, Should Consumer Disclosures Be Updated?, Presented at Understanding Consumer Credit, A National Symposium On Expanding Access, Informing Choices, and Protecting Consumers (Nov. 2007) (available at http://tinyurl.com/4qh2l3b).
[9] *Id.* at 15.
[10] *Id.* at 30-31.

revolving credit card (*e.g.*, use your Macy's Visa card and receive 10% of your purchase) that discount has to be allocated to either the payment function or the credit function. Likewise, if the consumer incurs a fee for using a particular card in a particular environment (*e.g.*, a fee for cross-border transactions) that fee must be allocated to either the payment function or the credit function.

Time introduces still more complexity. From a consumer perspective, time is what principally distinguishes revolving credit from installment credit. With an installment (or closed end) loan, a consumer receives a loan and, assuming a fixed interest rate and fixed repayment period, makes set payments over time. With a revolving line, on the other hand, a consumer receives the right to borrow up to a particular threshold. So long as the consumer has not exhausted the limit, he or she can increase the amount owed by making additional purchases. But this difference makes it very difficult to compare the terms of an installment loan with the terms of revolving credit. A consumer who borrows $2,000 on a twelve month installment plan at a 20% simple interest rate owes the lender $200 a month. A consumer with a revolving credit account limit of $2,000 who does not have outstanding charges will owe nothing.

The many possible definitions of "permit to understand" create additional problems. The Bureau could seemingly interpret "permit to understand" to require that a consumer (either idealized or actual) presented with a disclosure actually extract certain information from that disclosure—*i.e.*, "permit to understand" could be mean something close to "actually understand." Alternatively, "permit to understand" could mean that a financial institution must make truthful and accurate information available.

The text of Dodd-Frank also contains a "regulatory safe harbor." The Act allows to the Bureau to include a "model form" disclosure in any final rule it prescribes. The Act sets rules for any "model form." A model form must satisfy the following requirements:

- use plain language comprehensible to consumers;
- contain a clear format and design, such as an easily readable type font; and
- succinctly explain the information that must be communicated.[1]

A firm that uses any model form design by the Bureau satisfies its disclosure requirements.[11]

III. Professor Warren Leaves A Trail Of Bread Crumbs Showing How This Power Might Be Used.

The statutory framework provides the Bureau with an extraordinary degree of discretion. On the one hand, the Bureau could build on TILA's existing foundation, requiring that some information be disclosed clearly and conspicuously but otherwise simply identifying information that firms must provide to consumers. On the other hand, the Bureau could wield this power to remake the consumer financial industry by forcing firms to restructure consumer financial products in ways that all consumers actually understand. Professor Warren's academic writing suggests that she sees disclosure as a tool for remaking the industry.

The Bureau's power to dictate how firms disclose their products to consumers flows directly from Professor Warren's criticism of the consumer financial services industry. Professor Warren has long been critical of how lenders disclose their products

[11] § 1032(b).

to consumers. She has accused consumer credit of companies of "deliberately buil[ding] tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debts."[12] In her view, "[c]reating safer marketplaces is about making certain that the products themselves don't become the source of trouble."[13] This means "that terms hidden in the fine print or obscured with incomprehensible language, reservation of all power to the seller with nothing for the buyer, and similar tricks have no place in a well-functioning market."[14]

Professor Warren often uses credit cards to illustrate her concerns about the current regulatory regime and explain how a new regime might work. According to Professor Warren, "disclosure that runs on for pages is not real disclosure—it's just a way to hide more tricks."[15] She believes that eliminating the fine print and informing consumers of the price and the risk of financial products up front will allow consumers to effectively compare products and make better choices. Perhaps most noteworthy, Professor Warren has publicly suggested that credit card disclosures should be understood by approximately ***95%*** of users.[16]

Professor Warren has also suggested that "regulatory safe-harbors" of the sort built into Dodd-Frank can be used to force issuance of plain vanilla products. According to Professor Warren, financial institutions can limit their compliance burden by developing "plain vanilla" products that use "off-the-shelf" disclosure templates. As

[12] Elizabeth Warren, *Making Credit Safer: The Case for Regulation*, Harvard Magazine, May-June 2008, at 35 *available at* http://harvardmagazine.com/2008/05/making-credit-safer-html.
[13] *Id.*
[14] *Id.*
[15] *Id.*

[16] Elizabeth Warren, *Three Myths About the Consumer Financial Product Agency*, Guest post on The Baseline Scenario, http:// http://baselinescenario.com/2009/07/21/three-myths-about-the-consumer-financial-product-agency.

Professor Warren has explained, a financial institution can "fill[] in the blanks for interest rates, penalty rates and a few other key terms."[17] More complex products will not qualify for the safe-harbor, and Professor Warren implies that such products will be litigated or examined out of existence.

IV. Even Assuming That Disclosures Are Less Than Perfect, More Government Regulation Will Not Necessarily Make Them Better.

That the Bureau has the power to dictate the types of products and services that companies in the consumer finance industry can offer to consumers has received about as much attention as the meteors that, as Greg Easterbrook has explained, are headed our way and will (absent efforts to detect and deflect) add *homo sapiens* to the illustrious pantheon of extinguished species.[18] The most extreme use of the Bureau's disclosure power would mark an epochal shift in the consumer finance industry by forcing financial institution to standardize their products. The question is whether this shift is justified. Given the available empirical evidence about how consumers actually make choices and the flawed premise of the prevailing critique of existing disclosures, the answer to this question is no.

There is ample empirical evidence that consumers make sensible choices about how they use consumer credit. One fairly recent study examined how consumers make choices among different credit cards with different features. One card had an annual fee and a comparatively low interest rate. The other had a higher interest rate but no annual

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[17] Elizabeth Warren, *Three Myths About the Consumer Financial Product Agency*, Guest post on The Baseline Scenario, http:// http://baselinescenario.com/2009/07/21/three-myths-about-the-consumer-financial-product-agency.

[18] Gregg Easterbrook, *The Sky is Falling,* THE ATLANTIC, June 2008, *available at* *http://www.theatlantic.com/magazine/archive/2008/06/the-sky-is-falling/6807/3/.*

fee.[19] The study looked at how two hundred thousand consumers chose between the cards initially and how consumers switched between the cards when given the opportunity.[20]

The study found that on average, consumers chose the most appropriate credit contract.[21] And, "while relatively few consumers switched contracts," when given the opportunity, "those who made larger errors in their initial contract selection were more likely to subsequently switch to the optimal contract."[22] Although the credit card contracts offered during this "experiment" were simpler than most, the results suggest that consumers are capable of making logical credit decisions, and even re-evaluating and changing their decisions when necessary.

But there is a larger point at work. Professor Warren's critique of how the consumer financial industry works is based on a comparison between the actual and a hypothesized perfectly competitive version of that same industry. A quote from speech that Professor Warren gave last December at a speech to the Consumer Federation of America in Los Angeles explicitly makes this point:

> [T]he sellers of credit (banks like his) and the buyers of credit (American families) too often make deals with two very different understandings of the basic economics of the deal. ... This doesn't work. If the two parties to a contract don't actually have the same transaction in mind, then the fundamental premise of an efficient market—we both understand the deal and engage in deals that we think are good for us—is missing.[23]

[19] Argawal, Sumit, et. al., *Do Consumers Choose the Right Credit Contracts?* pg. 1 (November 2006), available at: hhtp;//ssrn.com/abstract=843826.
[20] *Id*. at 13.
[21] *Id*. at 4.
[22] *Id*. at 5.
[23] Elizabeth Warren, Priorties for the New Consumer Financial Protection Bureau (December 2, 2010) (available at http://tinyurl.com/4dtn2ev).

The final sentence captures the premise of Professor Warren's criticism of the industry that the market cannot protect consumers unless those consumers are fully informed about the consequences of their choices.

Although it is true that the model of perfect competition, familiar to everyone who sat through an introductory economic class in college, assumes the existence of fully informed consumers, that model is not a model of how competition is supposed to work.[24] Rather, the model of perfect competition emerged to support a critique of government policies that granted monopolies to private actors. The model demonstrated that a decentralized model of resource allocation could ensure an efficient distribution of resources (albeit under highly stylized assumptions). The absence of the conditions on which competition achieves the "efficient" outcome does not, however, imply that real world markets fail to protect consumers.

There are many differences between the real world and the world of perfect competition. Indeed, most of the things that characterize the real world are assumed away by the model of perfect competition, including transaction costs, differentiated products, differentiated consumers and differentiated consumers. But the most important difference between the real world and the hypothesized world, at least for purposes of thinking about how the Bureau might exercise its disclosure power, is the recognition that information is a good. Firms and consumers produce, exchange and consume it. The choices that firms and consumers make about how much information they choose to produce, exchange and consumer reflect cost/benefit decisions about the value of

[24] Harold Demsetz, *Information And Efficiency: Another Viewpoint* 12 J. Law & Econ. 1, 19 (1969).

acquiring additional information and the opportunity costs associated with that acquisition.[25]

Consider, for example, the cost/benefit calculation facing a consumer who is considering obtaining a credit card with the Visa logo. A consumer who has never been outside of the United States and has no plans to leave the United States is likely not particularly interested in comparing various Visa card on the basis of the fees imposed for foreign transactions. Even if a financial makes information about that dimension of its credit card contract available, it is by no means clear that the consumer would read that aspect of the disclosure or retain that information even if he or she did read that aspect of the card disclosure. And it seems obvious, at least within the confines of the hypothetical, that financial institutions should not be precluded from offering credit cards that work outside the United States (and charging a fee specific to that use) simply because that feature (and the price) are not of interest to all consumers (or 95% of all consumers).

This does not deny the government, through the Bureau or some other agency, a role in helping to devise better means of communicating information about financial products to consumers. Rather, it recognizes the enduring truth of what Harold Demsetz labeled the nirvana fallacy—the fact that real world markets outcomes fall short of idealized market outcomes does not suggest that real world governments will achieve better outcomes than real world markets.[26] Indeed, the last great attempt by the Federal

[25] *Id.* at 10. [better cite?]
[26] *Id.* at 1. The phrase "nirvana fallacy" is attributed to this famous paper by Demsetz, but the phrase does not appear in the paper. Although the paper identified three fallacies, none is labeled the "nirvana fallacy." Instead, the paper uses the phrase "nirvana approach."

government to correct the failure of financial institutions to communicate with their customers, the CARD Act of 2009, provides a vivid illustration of Demsetz's insight.

When President Obama signed the CARD Act into law, he highlighted a provision of the Act that would require financial institutions to communicate with their consumers how much those consumers would need to pay each month in order to retire their debts.[27] Last month, at a conference hosted by the CFPB to celebrate the CARD Act, Professor Warren praised this same provision.[28] Both the President and Professor Warren neglected to mention, however, that the government mandated calculation does not actually tell consumers what they need to pay in order to pay off their credit cards. The Federally mandated disclosures have a hidden flaw—the three-year calculation is prospective. It is based on the current outstanding balance, the current interest rate and a three-year term from the date of that statement.[29] Someone who wants to pay off a card in three-years actually has to stop using the card (or payoff all new charges) and pay the "three-year" amount on the first statement in order to retire the debt in three years. Otherwise, the debt will linger indefinitely into the future (or at least until the "three year" payment falls below the card issuer's monthly minimum).

[27] President Barack Obama, REMARKS BY THE PRESIDENT AT SIGNING OF THE CREDIT CARD ACCOUNTABILITY, RESPONSIBILITY AND DISCLOSURE ACT (May 22, 2009) (available at http://tinyurl.com/pew2no).

[28] Professor Elizabeth Warren, The CARD Act: One Year Later (Feb. 22, 2011) (available at http://www.treasury.gov/press-center/press-releases/Pages/tg1074.aspx).

[29] *See* 12 CFR 226 Appendix M, 7847 ("When calculating the estimated monthly payment for repayment in 36 months, a card issuer must calculate the estimated monthly payment amount that would be required to pay off the outstanding balance shown on the statement within 36 months, assuming the consumer paid the same amount each month for 36 months.").