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### Sea Changes in Consumer Financial Protection: Stronger Bureau and Stronger Laws

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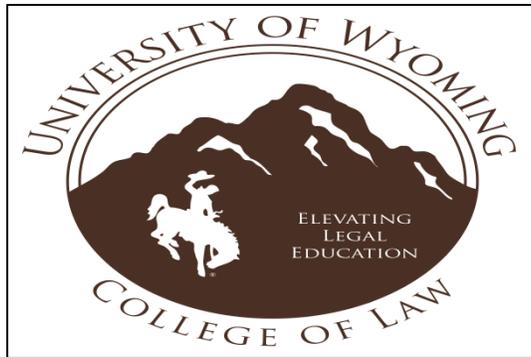
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# SEA CHANGES IN CONSUMER FINANCIAL PROTECTION: STRONGER AGENCY & STRONGER LAWS

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## SEA CHANGES IN CONSUMER FINANCIAL PROTECTION: STRONGER AGENCY AND STRONGER LAWS

By Dee Pridgen\*

**Abstract:** After the financial crisis of 2008, Congress responded by enacting new laws that changed the direction and theoretical underpinning of consumer protection in the financial sector. The Consumer Financial Protection Agency, formed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, is a new and stronger agency for consumers. Two pieces of legislation, the Mortgage Reform and Anti-Predatory Lending Act (Title XIV of Dodd-Frank), and the Credit Card Accountability, Responsibility and Disclosure Act (Credit CARD Act) of 2009, are stronger laws ensuring the safety of consumer financial products. These new legislative and regulatory developments mark a shift from the rational consumer theory that underlay the great disclosure statutes of the late 1960's and early 1970's, such as the Truth in Lending Act, and toward the rising influence of behavioral economics as a guiding force in consumer protection. This article examines the new agency and the new laws, explains how they differ from the prior governmental structure and precepts, compares and contrasts rational consumer theory and behavioral economics theory, demonstrates how the new developments are a reflection of the modern theory, and then analyzes the advantages and disadvantages of this new approach.

### I. Introduction

American consumer protection law is undergoing a “sea-change”<sup>1</sup> from what it was over 30-40 years ago to what it is today. The developments discussed in this article are the most important changes in the law since the

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<sup>1</sup> The phrase “sea-change” originated in *The Tempest*, by William Shakespeare, 1610. The full quote is:

Full fathom five thy father lies;  
Of his bones are coral made;  
Those are pearls that were his eyes:  
Nothing of him that doth fade  
But doth suffer a sea-change  
Into something rich and strange.

heyday of federal consumer protection legislation in the late 1960's and early 1970's.<sup>2</sup> It is also a sea change, or paradigm shift, in the basic underlying theories of consumer protection. This is reflected in the birth of the new Consumer Financial Protection Bureau, and in the shift from the use of pure disclosures under the rational choice theory of economics, to a system based on the more realistic view of consumer decision making as revealed by behavioral economics. This article will provide an overview of these changes, as well as the policies behind them.

As with most sea changes, a storm preceded these new developments. Most agree that the financial crisis of 2008 led to the current outpouring of new consumer legislation at the federal level.<sup>3</sup> The financial crisis that occurred following the collapse of the housing bubble, led to the loss of billions of dollars in the value of securities, especially mortgage-backed securities. When the stock market fell to record lows, a deep recession ensued. With the recession came a rise in unemployment, a loss in the value of homes, and an increase in debt.<sup>4</sup> Storm clouds that foreshadowed the financial tempest came in the form of a rise in subprime lending, including new forms of toxic and exotic mortgages,<sup>5</sup> and huge increases in household debt. Due to the securitization of mortgage loans, in which loans were bundled together and sold to investors, the risk of fraud and deception in the making of the loan was left with the consumer and with investors holding worthless mortgage-backed securities, while the real culprits were protected from such risks.<sup>6</sup>

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<sup>2</sup> This earlier era saw the passage of the Truth in Lending Act and associated consumer credit statutes now codified as the Consumer Credit Protection Act. 15 U.S.C.A. §§ 1601-1693. This was also the era that gave us the Magnuson-Moss Warranty/Federal Trade Commission Improvement Act, now codified at 15 U.S.C.A. §§ 2301-2312.

<sup>3</sup> See Leonard J. Kennedy, Patricia A. McCoy and Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 CORNELL L. REV. 1141, 1147-1149 (2012); Kyle C. Worrell, *Crisis as Catalyst for Federal Regulation in Financial Markets: The Rise of the Consumer Financial Protection Bureau*, 16 NEXUS: CHAP. J. L. & POL'Y 195 (2010-2011).

<sup>4</sup> FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (January, 2011). The Commission was established as part of the Fraud Enforcement and Recovery Act (Public Law 111-21).

<sup>5</sup> Consumer Federation of America, Allen J. Fishbein & Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* (May 2006), available at [http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/Exotic\\_Toxic\\_Mortgage\\_Report0506.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/Exotic_Toxic_Mortgage_Report0506.pdf).

<sup>6</sup> Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007).

Many policy makers concluded that these bad outcomes were at least in part caused by a lack of appropriate consumer protection regulation to curb some of the worst abuses by Wall Street investment firms and big banks. Congress filled this gap in 2009 and 2010 with an unprecedented wave of federal consumer protection legislation. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010<sup>7</sup> (Dodd-Frank Act) created a new federal consumer protection agency, the Consumer Financial Protection Bureau or CFPB, clothed with authority over all providers of consumer financial services of all kinds, and charged with protecting consumers from “unfair, deceptive or abusive” acts or practices in consumer financial services.<sup>8</sup> The Dodd-Frank Act also included the Mortgage Reform and Anti-Predatory Lending Act, which contains a major overhaul of the law of residential mortgages, including limits on unfair contract clauses, broker compensation and a new requirement that all lenders base loans on the consumer’s ability to repay, rather than solely on the collateral.<sup>9</sup> Just prior to the passage of the Dodd-Frank Act, in 2009, Congress had passed the Credit CARD Act,<sup>10</sup> which contained substantial new consumer protections with regard to credit cards, including limits on rate increases, reforms of creditor billing practices, and improvements on required disclosures.

This article will provide an overview of these new laws, explain how they differ from prior consumer protection laws, and will address the merits of this new direction in consumer protection. Part II discusses the creation of the CFPB, how it was based on the need to correct some structural flaws in the architecture of consumer protection in the financial sector, as well as the need for a consumer protection agency that could employ the insights of behavioral economics to fashion more effective regulations. A contrast between the new CFPB and the Federal Trade Commission,<sup>11</sup> which had been the major federal consumer protection agency in the United States for almost one hundred years, is also included in Part II. Part III describes a related shift in consumer financial protection from the purely disclosure remedies characteristic of the Truth in Lending Act, to the more substantive limitations that are characteristic of the Credit CARD Act and the Mortgage

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<sup>7</sup> Pub. Law No. 111-203, 124 Stat. 1376 (2010).

<sup>8</sup> 12 U.S.C. §§ 5491-5531.

<sup>9</sup> Pub. Law No. 111-203, 124 Stat. 1376, title XIV (2010), codified in scattered sections of 15 U.S.C. §§ 1639b-c. *See generally* DEE PRIDGEN & RICHARD M. ALDERMAN, CONSUMER CREDIT AND THE LAW Chapter 9A (West 2012-2013).

<sup>10</sup> Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734, codified in scattered sections of 15 U.S.C.A. § 1637.

<sup>11</sup> The FTC also has authority to regulate “unfair and deceptive acts or practices” as well as “unfair methods of competition.” 15 U.S.C.A. § 45(a)(1), and has both a Bureau of Consumer Protection and a Bureau of Competition.

Reform Act. This change in focus is arguably based on a move from the rational consumer choice theory that underpinned the Truth in Lending Act and other earlier consumer protection legislation, to more of a reliance on the relatively new field of behavioral economics. Part IV will describe in more detail the provisions of the Mortgage Reform and Anti-Predatory Lending Act and the Credit CARD Act to demonstrate the move from a reliance solely on consumer choice and rational choice theory, to a legal regime based more on the teachings of behavioral economics. Part V will conclude the article with an analysis of the disadvantages and advantages to consumers of the new approach to consumer protection documented in the preceding sections.

## **II. The Consumer Financial Protection Bureau**

### **A. The Structural Flaws in Consumer Financial Protection**

Prior to the creation of the CFPB, consumer financial protection at the federal level was not working effectively for consumers, due in part to the way it was set up. Under the federal umbrella statute known as the Consumer Credit Protection Act, consumer protection for financial services customers was spread out over several bank regulatory agencies and the Federal Trade Commission,<sup>12</sup> with each of the bank regulatory agencies having sometimes conflicting missions of ensuring the safety and soundness of their regulatory “clients.” No one agency focused on the whole spectrum of consumer financial protection. The Federal Trade Commission (FTC) has an overall consumer protection focus but no jurisdiction over banks. The FTC only regulates nonbank entities that offer financial services.<sup>13</sup> Bank regulatory agencies had jurisdiction over banks, but did not have an overall consumer protection focus.<sup>14</sup>

While consumers under the prior regulatory scheme were not being well served in their efforts to shop around for the best deal in credit products, regulated banks could shop around for the best (least interfering) regulator by choosing to be chartered by either the state or federal government. Those regulators both enforced consumer protection and other rules on their chartered entities, and derived revenues from them. Thus, if one chartering

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<sup>12</sup> 15 U.S.C. § 1607, § 1681s, §1692l, and § 1693o.

<sup>13</sup> 15 U.S.C. § 45(a)(2).

<sup>14</sup> See Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, 85-97 157 U. PA. L. REV. 1 (2008); Adam J. Levitin, *The Consumer Financial Protection Agency*, Pew Financial Reform Project Briefing Paper # 3, available at [http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Financial\\_Reform/Pew-Levitan-CFPA.pdf](http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Financial_Reform/Pew-Levitan-CFPA.pdf).

entity imposed unwelcome regulation on a bank, the regulated bank might choose to change its charter to a more compatible agency. The competition among agencies for regulatory clients was said to be a “race to the bottom” because the banks chose, and the regulatory agencies offered, the least possible amount of regulation despite the interest of consumers in protection from certain abuses.<sup>15</sup> Many states attempted to impose some limits on federally-chartered banks that were alleged to be engaging in predatory lending practices, but these state laws were preempted and the federal regulators did not offer consumers equivalent protection.<sup>16</sup> Indeed, some critics viewed federal preemption as a covert effort to deregulate the residential lending market.<sup>17</sup> This strong federal preemption was extended to subsidiaries of national banks as well.<sup>18</sup> Also, under an historic ruling by the Supreme Court in 1978, a federally-chartered bank would be governed by the usury and other laws of the state in which the bank was located, rather than where the borrower was located.<sup>19</sup> This gave banks the incentive to choose a federal charter and locate in states with very little consumer protection regulation.

### **B. How the Legislation and the CFPB Address These Structural Flaws**

The Dodd-Frank Act addressed these structural issues regarding consumer financial protection when it created the Consumer Financial Protection Bureau (CFPB).<sup>20</sup> This move will change the face of consumer protection for years to come. The new agency was formed by consolidating the consumer protection divisions of existing bank regulatory agencies, such as the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA), and placing them under the umbrella of a single agency whose sole mission is consumer financial protection.<sup>21</sup>

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<sup>15</sup> Adam Levitin, *supra* n. 14, at p. 6-7.

<sup>16</sup> *See, e.g.*, 12 C.F.R. §§ 34.3, 34.4, 7.4000, 7.4007, 7.4008, and 7.409.

<sup>17</sup> Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 *TEMPLE L. REV.* 1 (2005).

<sup>18</sup> *See* *Watters v. Wachovia Bank*, 550 U.S. 1, 127 S. Ct. 1559 (2007).

<sup>19</sup> *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

<sup>20</sup> The design of the new agency is widely credited to Elizabeth Warren, a Harvard Law Professor (now a United States Senator) who acted as a Presidential Assistant to set up the CFPB. *See* Elizabeth Warren, *Unsafe at Any Rate*, *DEMOCRACY*, Issue # 5, (Summer 2007).

<sup>21</sup> 12 U.S.C.A. § 5581.

Thus, there is no incentive for either the regulator or the regulated entities to shop around for a better deal because all of the regulatory authority over consumer financial services is under one roof, as it were. Also, under the current law, the applicable regulation does not depend on type of entity or type of financial product, so there will be more of a level playing field across all sectors of consumer financial services. Another feature of the new law is that the CFPB has authority to enforce all the pre-existing consumer financial services laws, the so-called “enumerated laws,” which mostly consist of the statutes included in the Consumer Credit Protection Act, such as the Truth in Lending Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, Equal Credit Opportunity Act and the Electronic Funds Transfer Act. These laws had previously been enforced by the FTC and the bank regulatory agencies, with the Federal Reserve Board authoring the relevant regulations.<sup>22</sup>

The Dodd-Frank Act eliminated much federal preemption of state consumer protection law, so banks no longer have a motive to change charters to get a better deal from the federal regulatory agencies. The new law contains a specific preemption provision that cuts back significantly on federal preemption and allows much more leeway for states to enforce their own consumer protection laws in the area of consumer financial protection, as long as the state laws are not inconsistent with federal law and are more protective of consumers than the federal standard.<sup>23</sup> Thus the federal law is a floor or minimum level of consumer protection but states can be more protective if they deem it necessary. This is the same type of preemption standard as that found in the Truth in Lending Act,<sup>24</sup> which allows the states to act as laboratories for different consumer protection measures to be tried out prior to adoption at the federal level. A possible downside of this provision is that consumer credit providers may end up facing varying requirements across different states, which can add to compliance costs.<sup>25</sup>

### **C. The CFPB Is More Powerful and Potentially More Effective Than the FTC**

When designing the Consumer Financial Protection Bureau, Congress had before it several different templates of regulatory agencies. First, the traditional independent regulatory agencies, such as the Federal Trade

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<sup>22</sup> 12 U.S.C.A. §§ 5481(12), (14), and 5564 & 5565,

<sup>23</sup> 12 U.S.C.A. § 5551(a)(1) & (2).

<sup>24</sup> 15 U.S.C.A. § 1610.

<sup>25</sup> David S. Evans & Joshua D. Wright, *The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit*, 22 LOY. CONSUMER L. REV. 277 (2010).

Commission and the Securities and Exchange Commission, were created by Congress to operate outside of the direct control of the executive branch, but with some oversight and involvement by both the federal legislature and the executive branch. These agencies also have some guarantees of independence, such as set terms for Commissioners, and no veto powers. The independent regulatory agencies are also funded by Congress and can be controlled indirectly by that means. The Federal Reserve System has a Board of Governors appointed by the President and confirmed by the Senate, much like the independent regulatory agencies, but it is also the central banking system and derives much of its revenue from the banks that participate in the federal reserve system.<sup>26</sup> A percentage of this revenue goes to fund the Federal Reserve Board, making it less dependent on Congress than the other regulatory agencies.

The CFPB is different from the model of either the independent regulatory agency as embodied by the FTC, or the Federal Reserve Board, of which the CFPB is a part. The Federal Trade Commission was created by Congress in 1914. It has been the major American consumer protection agency since the 1930's, when Congress added a specific consumer protection mission to the FTC Act. In 2010, almost one hundred years after the FTC was established, the legislation creating the CFPB used a template, which is a bit of a hybrid between the independent regulatory agency model and the Federal Reserve Board. There are several pertinent differences between the CFPB and the FTC that make the CFPB arguably a stronger and hence more effective protector of consumers than the FTC. Each of these differences will be discussed in turn below.

First, the CFPB has a different funding mechanism than the FTC. The CFPB is an "independent bureau" within the Federal Reserve System,<sup>27</sup> is funded by revenues from Federal Reserve, and is guaranteed further appropriations (within stated limits) on request by the CFPB Director.<sup>28</sup> This is similar to the funding of other bank regulatory agencies, such as the Federal Reserve itself, and the Office of the Comptroller of the Currency. The FTC, by contrast, is funded by Congress, and has been limited in the past by Congressional exercise of the "power of the purse." For example, when the FTC proposed to ban television advertising aimed at children in the late 1970's, a proposal known as the "kid-vid" rule, Congress cut off funding for any FTC rule based on the "unfairness" prong of its statute.<sup>29</sup>

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<sup>26</sup> <http://www.federalreserve.gov/pf/pf.htm>, Federal Reserve System, Purposes & Functions, Chapter One, at p. 11 (last updated Aug. 24, 2011).

<sup>27</sup> 12 U.S.C.A. § 5491(a).

<sup>28</sup> 12 U.S.C.A. § 5497.

<sup>29</sup> See J. Howard Beales, III, *Advertising to Kids and the FTC: A Regulatory Retrospective that Advises the Present*, 12 GEO. MASON L. REV. 873, 878-880 (2004).

Having the CFPB funded more like its bank regulatory predecessors, by contrast, was intended by Congress when it wrote the legislation to avoid such political turmoil and possibly undue strangulation of the agency.

A second difference between the CFPB and the FTC is the way the agency is internally governed and organized. The CFPB is run by a single director, appointed by the President and approved by the Senate, for a five-year term.<sup>30</sup> By contrast, the FTC is run by five commissioners, also appointed by the President and approved by the Senate for seven-year staggered terms. No more than three FTC commissioners can be from the same political party.<sup>31</sup> The need for the FTC Commissioners to muster a majority of their number to approve any action may provide somewhat of a brake on the consumer protection activities of the FTC, whereas an agency like the CFPB with a single director may be able to take action more swiftly when needed to address emergent consumer issues.<sup>32</sup> The CFPB also has four “special function units” that focus on particular issues or populations, within the new agency. These units include the Office of Fair Lending and Equal Opportunity, the Office of Financial Education, the Office of Service Member Affairs, and the Office of Financial Protection for Older Americans.<sup>33</sup> The FTC, on the other hand, historically has been divided into a Bureau of Consumer Protection, a Bureau of Competition, and a Bureau of Economics.

Third, the CFPB has authority to take action to prevent “unfair, deceptive and abusive practices” within the scope of their jurisdiction, i.e., consumer financial service transactions.<sup>34</sup> The FTC, on the other hand, has authority over unfair or deceptive practices only.<sup>35</sup> The field of unfair and deceptive trade practices under the FTC Act has a long history and such practices are well-defined both in policy statements and in case precedent.<sup>36</sup> The unfairness standard is defined in the CFPB’s statute using the same

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<sup>30</sup> 12 U.S.C.A. § 5491(b) & (c). The current CFPB director, Richard Cordray, is a recess appointment whose term will run out in 2013. At that time the President will need to appoint a director under the statute, which will require approval by the Senate. This appointment has been the subject of political controversy, which may prove to be an obstacle to the continuing work of the CFPB after the recess appointment expires.

<sup>31</sup> 15 U.S.C.A. § 41.

<sup>32</sup> Note that the OCC also functions under a single director, not a commission.

<sup>33</sup> 12 U.S.C.A. § 5493(b)-(g).

<sup>34</sup> 12 U.S.C.A. § 5531(a).

<sup>35</sup> 15 U.S.C.A. § 45(a).

<sup>36</sup> FTC Policy Statement on Deception (1983), available at <http://www.ftc.gov/bcp/policystmt/ad-decept.htm>; FTC Policy Statement on Unfairness (1980), available at <http://www.ftc.gov/bcp/policystmt/ad-unfair.htm>, codified at 15 U.S.C.A. § 45(n). *See generally* DEE PRIDGEN & RICHARD M. ALDERMAN, CONSUMER PROTECTION AND THE LAW, Chapters 9-11 (West, 2012-13 ed.).

definition as in the FTC Act.<sup>37</sup> The CFPB statute does not specifically define “deceptive” practices, but the Bureau has indicated in its “Examination Manual” that it will adopt the FTC policy statements and precedents on the meaning of “deceptive practices” (as well as “unfair practices”) in the financial services context.<sup>38</sup> The CFPB’s additional authority to curb “abusive practices” creates a new standard, defined in the statute but not yet tested. The Act defines an “abusive” practice as one that

- (1) Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- (2) Takes unreasonable advantage of –
  - (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
  - (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.<sup>39</sup>

This standard provides the CFPB with a unique and flexible authority to deal with abuses in the consumer financial services sector,<sup>40</sup> and to issue rules or initiate enforcement actions to address the exploitation of certain consumer behavioral biases by financial service providers.<sup>41</sup> While the “abusive practices” power is broad and currently uncharted, the statutory language does create a framework against which any CFPB initiative based on this provision must be measured. Also, it should be noted that while the CFPB may have a broader general statutory mandate

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<sup>37</sup> 12 U.S.C.A. § 5531(c).

<sup>38</sup> Consumer Financial Protection Bureau, *Supervision and Examination Manual 2.0*, at 178-181 (October 2012), available at [http://files.consumerfinance.gov/f/201210\\_cfpb\\_supervision-and-examination-manual-v2.pdf](http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf).

<sup>39</sup> 12 U.S.C.A. § 5531(d).

<sup>40</sup> See Carey Alexander, Note, *Abusive: Dodd-Frank Section 1031 and the Continuing Struggle to Protect Consumers*, 85 ST. JOHN’S L. REV. 1108 (2011), for a general discussion of the legislative history of this section and analysis of the types of activities to which it might be applied. See also Tiffany S. Lee, *No More Abuse: The Dodd-Frank and Consumer Financial Protection Act’s “Abusive” Standard*, 14 J. CONSUMER & COM. L. 118 (2011).

<sup>41</sup> See Jean Braucher, *Form and Substance in Consumer Financial Protection*, Arizona Legal Studies, Discussion Paper No. 12-25, available at <http://ssrn.com/abstract=2126859>.

than the FTC by including coverage of “abusive” practices in addition to unfair and deceptive practices, the CFPB’s authority is narrower in focus than the FTC’s. It has authority only over persons who offer or provide consumer financial products or services. In addition, the CFPB’s authorizing statute contains specific exemptions from CFPB jurisdiction of merchants selling nonfinancial goods or services, motor vehicle dealers, persons regulated by the Securities and Exchange Commission, persons regulated by a state insurance regular, real estate agents, accountants, non-credit -extending tax preparers, attorneys and others.<sup>42</sup> The CFPB’s potential regulatory action thus affects a smaller segment of the economy, but one that had proven particularly troublesome for consumers in the recent financial crisis that led up to the legislation.

Fourth, the CFPB has a more efficient and straightforward rulemaking authority than the FTC. As a tool to implement its statutory mandate, the CFPB has general rulemaking authority to curb unfair, deceptive and abusive practices using standard federal rulemaking procedures,<sup>43</sup> as contained in the Administrative Procedures Act’s (APA) notice and comment process.<sup>44</sup> The CFPB’s regulations are subject to review, however, and can be set aside if the Financial Stability Oversight Council determines that the regulation “would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.”<sup>45</sup> The FTC, on the other hand, did not obtain industry-wide rulemaking authority to regulate unfair and deceptive trade practices until 1975, more than 50 years after the agency was established. The FTC’s rulemaking authority was part of the Magnuson-Moss Warranty - FTC Improvement Act,<sup>46</sup> and it contains many procedural hurdles that have had the effect of preventing most FTC trade regulation rules from being promulgated. One problem with so-called Magnuson-Moss rulemaking at the FTC is that it is an adjudication-like process, involving virtually unlimited witnesses and parties, which results in an inefficient and drawn-out process.<sup>47</sup> The result has been that for the past several decades,

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<sup>42</sup> 15 U.S.C. A. § 5517.

<sup>43</sup> 12 U.S.C.A. §§ 5512 and 5531(b).

<sup>44</sup> 5 U.S.C.A. §§ 553 and 706.

<sup>45</sup> 12 U.S.C.A. § 5513(a). The CFPB’s regulations are also subject to the normal rulemaking checks, such as the small business impact requirement, 5 U.S.C.A. § 601, the Congressional cost-benefit review requirement, 5 U.S.C.A. § 801, and a cost benefit review by the Office of Information and Regulatory Affairs within the Office of Management and Budget. 44 U.S.C.A. § 3501.

<sup>46</sup> 15 U.S.C.A. § 57a(a)(1)(B). Further restrictions on the FTC’s rulemaking process were added by the FTC Improvements Act of 1980, Pub. L. No. 96-252, 94 Stat. 374 (1980), codified at 15 U.S.C.A. § 57b-3.

<sup>47</sup> See Testimony of Dee Pridgen before the Senate Subcommittee on Consumer

the FTC has issued regulations only when specifically directed to do so by Congress, and where it is authorized to use APA notice and comment rulemaking, as it was in the Telemarketing Sales Act.<sup>48</sup> APA rulemaking is a much more efficient process and is the norm for most federal agencies other than the FTC. As a result of this legislative peculiarity, the FTC has not issued many regulations under its more general “unfair and deceptive trade practices” authority.<sup>49</sup> Thus, the CFPB could potentially be better situated than the FTC to issue rules governing unfair, deceptive or abusive financial services practices in the future. Whether and how the CFPB will use this rulemaking authority remains to be seen.

Despite the potential for bureaucratic warfare between two agencies both charged with consumer protection, the CFPB and the FTC are poised to become partners rather than rivals. The CFPB has been given enforcement authority over unfair, deceptive and abusive practices engaged in by consumer financial service providers, as well as enforcement authority for specific consumer credit statutes.<sup>50</sup> Meanwhile, the FTC still has authority to enforce its own statute as well as to enforce the consumer credit statutes (concurrently with the CFPB) with regard to nonbank entities.<sup>51</sup> The statute specifically requires the CFPB to coordinate with the FTC and other relevant agencies “to promote consistent regulatory treatment of consumer financial and investment products and services.”<sup>52</sup>

As to unfair, deceptive or abusive practices under either agency’s jurisdiction, there is no private right of action,<sup>53</sup> which limits enforcement to the relevant government agencies. This includes state governments in some cases as well, given that there are provisions for state government enforcement of matters under the jurisdiction of both the CFPB and the FTC.<sup>54</sup> However, there remains a pre-existing private right of action to

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Protection, Product Safety, and Insurance, United States Senate, (March 17, 2010).

<sup>48</sup> 15 U.S.C.A. § 1602(b), resulting in the promulgation of the Telemarketing Sales Rule, 16 C.F.R. Part 310.

<sup>49</sup> DEE PRIDGEN & RICHARD M. ALDERMAN, *CONSUMER PROTECTION AND THE LAW*, § § 12:10-12:14 (West, 2012-13 ed.).

<sup>50</sup> Leonard J. Kennedy, Patricia A. McCoy and Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 *CORNELL L. REV.* 1141, 1147-1149 (2012).

<sup>51</sup> 12 U.S.C.A. § 5581(b)(5).

<sup>52</sup> 12 U.S.C.A. § 5495. *See also* 12 U.S.C.A. § 5514(c).

<sup>53</sup> There is nothing in either the CFPB statute or in the FTC Act specifically creating a private right of action. A theory that such a cause of action was implied in the FTC Act was definitively rejected in *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986 (D.C. Cir. 1973). *See generally* DEE PRIDGEN & RICHARD M. ALDERMAN, *CONSUMER PROTECTION AND THE LAW*, § 12:43 (West, 2012-13 ed.).

<sup>54</sup> *See* 12 U.S.C.A. § 5552 for the CFPB. Many federal consumer laws have provisions for state government enforcement, including many that are jointly enforced by

enforce specific consumer credit statutes, such as TILA, ECOA, FCRA or FDCPA,<sup>55</sup> which has been in place since the outset of these statutes.

The CFPB was created to be more powerful than the well-established FTC, due in part to a growing realization by Congress that consumers needed an agency that could act more quickly and effectively to protect consumers than the FTC or the bank regulatory agencies that preceded it. In addition, the CFPB is poised to take advantage of the current shift in consumer behavior theory underpinning the law of consumer protection, a shift away from the rational consumer choice theory that supported a predominantly consumer disclosure regime, and toward the more realistic and evidence-based theory of behavioral economics.

### **III. From “Homo Economicus” to Real Consumers**

#### **A. New Consumer Protection Law Tilts Toward “Behavioral Economics”**

The creation of the CFPB was a distinct innovation in the design of consumer protection agencies. As discussed above, the CFPB is neither an independent regulatory agency nor a bank regulatory agency, but is something new and more potent, meant to deal more effectively with a specific consumer protection sector, namely financial services. But the creation of the CFPB itself is not the only big change in the consumer protection landscape. In addition, certain federal statutes passed in 2009 and 2010 represent a major shift in their underlying theoretical basis from the older consumer credit laws. The older statutes and associated regulations relied on the hypothetical rational consumer (“homo economicus”) to make rational choices when presented with all relevant information. The new laws that will be discussed below, on the other hand, incorporate the findings of behavioral economics, namely that real consumers do not always act rationally in their own self-interest in making marketplace decisions. Two areas in particular, involving residential mortgages (addressing predatory residential mortgage lending practices) and credit cards, are examples of this shift in legislative philosophy.

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the FTC. See Amy Widman & Prentiss Cox, *State Attorneys General’s Use of Concurrent Public Enforcement Authority in Federal Consumer Protection Laws*, 33 CARDOZO L. REV. 53 (2011).

<sup>55</sup> 15 U.S.C.A. § 1640 (TILA); 15 U.S.C.A. § 1681n & 1681o (FCRA); 15 U.S.C.A. § 1691e (ECOA); 15 U.S.C.A. § 1692k (FDCPA).

The last big wave of federal consumer protection can be traced back to the late 1960's and early 1970's when the Truth in Lending Act (TILA) and related consumer credit laws were passed and were codified under the umbrella statute – the Consumer Credit Protection Act.<sup>56</sup> Those laws, especially the TILA which aimed to enhance comparative shopping for consumer credit, were based on the economic theory that informed consumers would choose wisely in the marketplace. It was presumed that if the law provided consumers with standardized information about the comparative costs of competing credit products, then the competitive marketplace would be able to function to maximize consumer welfare.<sup>57</sup> This is known as rational choice theory, premised on the existence of “homo economicus,” a rational consumer choice maker, who by making rational choices based on individual preferences, will lead to the best economic outcome for the market as a whole.<sup>58</sup> Based on this theory, much of consumer credit law took a pure disclosure approach to consumer protection, in which consumers were given relevant information about competing credit products, and were expected to choose the one that maximized their welfare.<sup>59</sup> Disclosure of information was viewed as a panacea for imperfections in the market for consumer credit, because in theory disclosures of information alone could protect consumers and promote competition, while imposing the least cost on the market and meeting with the least amount of political resistance.<sup>60</sup>

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<sup>56</sup> 15 U.S.C.A. §§ 1601-1693r. See DEE PRIDGEN & RICHARD M. ALDERMAN, *CONSUMER CREDIT AND THE LAW*, Chapter 4 (West, 2012-13 ed.).

<sup>57</sup> See Edward L. Rubin, *Legislative Methodology: Some Lessons from the Truth in Lending Act*, 80 GEO. L.J. 233 (1991); Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807 (2003).

<sup>58</sup> See Matthew A. Edwards, *The FTC and New Paternalism*, 60 ADMIN. L. REV. 323, 325-328 (2008); Maurice E. Stucke, *Money, Is that What I Want?: Competition Policy and the Role of Behavioral Economics*, 50 SANTA CLARA L. REV. 893, 899-901 (2010).

<sup>59</sup> Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807 (2003).

<sup>60</sup> Dee Pridgen, *Putting Some Teeth in TILA: From Disclosure to Substantive Regulation in the Mortgage Reform and Anti-Predatory Lending Act of 2010*, 24 LOY. CONSUMER L. REV. 615 (2012).

The impetus for the recently manifested change in approach to consumer protection in the financial sector came from the work of behavioral economics scholars. This research, which has resulted in the publication of influential studies and articles from the 1990's to the 2000's and present, questioned the premise that consumers would always act rationally in their own self-interest if presented with adequate information.<sup>61</sup> Basically, these scholars concluded that rational choice theory does not accurately describe how consumers actually behave in the marketplace.<sup>62</sup> Behavioral economics scholars focused on certain cognitive barriers that prevent most consumers from choosing rationally, and also revealed that marketers of credit products may have actually exploited these flaws in consumer decision-making for their own benefit.<sup>63</sup> The new laws in the consumer finance sector appear to take this new learning about the consumer marketplace behavior to heart, and as a result, we are seeing laws that feature more substantive limits, more pro-consumer default provisions, and more disclosures based on consumer-behavior studies.

### **B. Why Disclosures Alone Did Not Prevent the Financial Crisis**

Truth in Lending disclosures were well-established in the period leading up to the foreclosure crisis of 2007-08. They are required for mortgage loans, which tend to be for relatively large sums of money in transactions that often take several weeks to be finalized, as well as for the opening of a credit card account, which can be approved on the spot or in a very short time. In both situations, consumers did not appear to heed the warnings of minefields ahead that were spelled out in the federally-mandated disclosures and ultimately found themselves unable to pay their debts.<sup>64</sup> These problems could have included a pre-determined jump in monthly payments or interest rates to unaffordable levels after the expiration of an initially

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<sup>61</sup> See, e.g., Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249 (2006); Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749 (2008); Alan M. White, *Behavior and Contract*, 27 LAW & INEQ. 135 (2009).

<sup>62</sup> Edward L. Rubin, *Rational Choice and Rat Choice: Some Thoughts on the Relationship Among Rationality, Markets, and Human Beings*, 80 CHI.-KENT L. REV. 1091 (2005).

<sup>63</sup> See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004).

<sup>64</sup> Jeff Sovern, *Preventing Future Economic Crises Through Consumer Protection Law Or How the Truth in Lending Act Failed the Subprime Borrowers*, 71 OHIO ST. L.J. 761 (2010).

lower payment period, and pre-payment penalties that would make refinancing of a mortgage too expensive at the time when the payments became unaffordable. Other aspects of many mortgage loans that should have waved large red flags in the face of a rational decision maker with a limited income include variable rates, “interest only” payments, negative amortization, and balloon payments.<sup>65</sup> As for credit card deals, the solicitation disclosures should have warned consumers that the initial low rate was set to expire in a relatively short time, that the creditor could change the contract terms at any time, and that there were going to be hefty penalties for late payments and over-the-limit charges.<sup>66</sup> So why did so many consumers appear to choose irrationally even when presented with all the relevant terms and costs?

For the mortgage loan consumer, buying a home is often said to be the largest financial investment in a person’s lifetime. And yet instead of resulting in more caution, such a high-stakes transaction sometimes results in the triggering of certain defense mechanisms that may cloud rational judgment.<sup>67</sup> When faced with such a great deal of information, consumers may experience “information overload” and will only consider those variables that are most salient, such as the amount of the closing costs and the initial monthly payment.<sup>68</sup> Borrowers who feel insecure about their creditworthiness may be overly trusting of a broker or lender representative, even if what the broker/lender says is contradicted by written disclosures.<sup>69</sup>

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<sup>65</sup> Consumer Federation of America, Allen J. Fishbein & Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* (May 2006), available at [http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/Exotic\\_Toxic\\_Mortgage\\_Report0506.pdf](http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/Exotic_Toxic_Mortgage_Report0506.pdf).

<sup>66</sup> 15 U.S.C.A. § 1637(c); 12 C.F.R. § 226.5a [12 C.F.R. § 1026.5a].

<sup>67</sup> Debra Pogrund Stark & Jessica M. Choplin, *A Cognitive and Social Psychological Analysis of Disclosure Laws and Call for Mortgage Counseling to Prevent Predatory Lending*, 16 *PSYCHOLOGY, PUBLIC POLICY AND LAW* 85 (2010).

<sup>68</sup> See Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 *AKRON L. REV.* 725 (2005); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 *MD. L. REV.* 707, 768 (2006).

<sup>69</sup> See Debra Pogrund Stark & Jessica M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 *N.Y.U. J.L. & BUS.* 617 (2009); Jessica M. Choplin, Debra Pogrund Stark & Jasmine N. Ahmad, *A Psychological Investigation of Consumer Vulnerability to Fraud: Legal and Policy Implications*, 35 *LAW & PSYCHOL. REV.* 61 (2011).

Also, due to the “endowment effect” of feeling they already own the home being financed, consumers may not want to unwind the transaction once unfavorable credit terms are presented.<sup>70</sup> Another well-known behavioral tendency of most consumers is to be overly optimistic about the future. Thus, when faced with a contract disclosure that rates or payments are likely to go up at a future point in time, many consumers will optimistically assume that real estate prices will also go up, or that their own incomes will rise, so that future penalties, balloon payments or the inability to pay higher payments will not be a problem.<sup>71</sup> This type of unrealistic optimism or wishful thinking can lead consumers to make choices that are not necessarily in their own self-interest.

Irrational consumer behavior can also play a role in credit card choices in ways that are not likely to be alleviated by disclosure alone. Credit card debt skyrocketed in the years prior to the recent financial crisis.<sup>72</sup> Just as mortgage lenders were required to make certain information disclosures to consumers prior to their commitment to a loan, federal consumer protection law requires credit card issuers to make certain credit cost information disclosures to consumers with any credit card solicitation.<sup>73</sup> Quite often, card issuers offered low “teaser rates” or “no annual fee” in credit card offers, which were followed by increased rates or the imposition of an annual fee after the card offer had been accepted and the consumer had run up a balance.<sup>74</sup> Credit card agreements specified that terms could be changed by the card issuer at any time, but most consumers may have optimistically assumed that this would not affect them. Also, consumers are often found to be “myopic” in the sense that they focus on the short-term costs and do not see that far into the future when making marketplace choices. Another phenomenon that may occur is “hyperbolic discounting,” by which consumers may overvalue the immediate costs and

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<sup>70</sup> Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U.L. REV. 630, 734 (1999).

<sup>71</sup> Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2009).

<sup>72</sup> Credit card debt increased by 25% in the ten years preceding 2009, and reached \$963 billion in January of that year. Also, at that time, more than 75% of all U.S. families had a credit card and 44% carried a balance. House Report 111-88 (April 27, 2009).

<sup>73</sup> 15 U.S.C.A. § 1637(c); 12 C.F.R. § 226.5a [12 C.F.R. § 1026.5a].

<sup>74</sup> See, e.g., *Rossman v. Fleet Bank*, 280 F.3d 384 (3d Cir. 2002).

benefits of a credit card deal, while undervaluing the future costs and benefits.<sup>75</sup> Thus, a fully-disclosed temporary low teaser rate in a credit card agreement may encourage consumers to accept the card, and borrow fairly heavily during the teaser rate period, on the assumption that they will pay off the balance before the low rate expires. Optimistically, consumers may also assume that when the rate goes up, that they will cease using the card, or use it less, which is not always the case.<sup>76</sup> In addition to rates, all potential fees associated with credit cards are required to be disclosed prior to the account opening.<sup>77</sup> However, certain “back end” fees and penalties such as over-the-limit fees, late fees, and penalty rates are not “salient” to consumers in choosing credit cards, even though they are fully disclosed, because these items do not take effect until later, if at all. Even consumers who notice these fees and potential rate increases may optimistically assume that they will not charge over their limit, will not pay late and will not default, so they do not factor in these costs when choosing credit cards.<sup>78</sup> Once consumers incur these additional costs, they face switching costs to change to another card. Such costs include time spent shopping for information on alternatives, paying off or transferring the balance on their current card, changing previously established online or automatic payments with their bank, and so on. Thus, the initial short-sighted choice of a credit card is somewhat costly to correct.

#### **IV. New Substantive Provisions for Consumers under New Federal Laws**

Given the shortcomings of the pure disclosure approach, as outlined above, Congress changed course in the areas of residential mortgage loans and credit cards. In two major consumer protection laws, the Mortgage Reform and Anti-Predatory Lending Act of 2010 and the Credit CARD Act of 2009, Congress took more of a substantive approach to consumer

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<sup>75</sup> Jonathan Slowik, Comment, *Credit CARD Act II: Expanding Credit Card Reform by Targeting Behavioral Biases*, 59 UCLA L. REV. 1292, 1311-1313 (2012).

<sup>76</sup> Adam J. Levitin, *Rate-Jacking: Risk-Based & Opportunistic Pricing in Credit Cards*, 2011 UTAH L. REV. 339 (2011).

<sup>77</sup> 12 C.F.R. § 226.5a(b) [12 C.F.R. § 1026.5a(b)] .

<sup>78</sup> Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The CARD Act and Beyond*, 97 CORNELL L. REV. 967 (2012).

protection, combined with improved disclosures based on consumer behavior research. The substantive approach relies less on the informed rational consumer to make the right choice based on mandated disclosures and more on the law to provide minimum standards of fair dealing with consumers. Some say this new type of law will result in the unmooring of consumer protection law from its foundation in the consumer welfare theories of antitrust economics.<sup>79</sup> Others say this new approach is a more realistic and effective way to protect consumers.

### A. Residential Mortgage Loans

It is commonly agreed that the prevalence of certain types of “toxic” or “exotic” subprime mortgages, that contained complex and consumer unfriendly clauses, may have contributed to the rash of mortgage foreclosures that started in 2007-2008. When housing prices started to plummet, many consumers realized they were locked into loans that they could not afford due to increasing adjustable rates, “teaser” rates that were replaced with much higher rates and payments, sky high balloon payments, prepayment penalties that prevented refinancing, and financing arrangements such as “interest only” payments that resulted in negative amortization on their property.<sup>80</sup> In response, Congress passed Title XIV of the Dodd-Frank Act, which was called the Mortgage Reform and Anti-Predatory Lending Act of 2010.<sup>81</sup> This law is set to come into effect in early 2013,<sup>82</sup> and it contains many pro-consumer provisions that go well beyond disclosure and rational consumer choice.<sup>83</sup> At the same time, disclosure and consumer choice has not been abandoned as a regulatory stance. Indeed, the Dodd-Frank Act also contains some specific directions to the new CFPB to improve the usefulness and readability of early mortgage disclosures.

The CFPB is charged with combining and improving the readability of early mortgage loan cost disclosures by combining the two separate

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<sup>79</sup> Joshua D. Wright, *The Antitrust/Consumer Protection Paradox: Two Policies At War With Each Other*, 121 YALE L.J. 2216 (2012).

<sup>80</sup> Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243, 1252-1254 (2011).

<sup>81</sup> Pub. Law No. 111-203, 124 Stat. 1376 (2010).

<sup>82</sup> The effective date of most of the provisions of the Mortgage Reform Act is January 21, 2013. Pub. L. 111-203, Sec. 1400(c), 124 Stat. 1376 (2010).

<sup>83</sup> See generally Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett, & Arthur B. Axelson, *Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform under the Dodd-Frank Act*, 66 BUS. LAW. 457 (Feb. 2011).

disclosures that had previously been mandated by two different regulatory agencies, the Federal Reserve Board (FRB) under TILA and the Department of Housing and Urban Development (HUD) under the Real Estate Settlement Procedures Act (RESPA).<sup>84</sup> This new disclosure will replace two confusing and sometimes conflicting disclosures under the old law that came from FRB and HUD.<sup>85</sup> The CFPB in 2011 launched an extensive “Know Before You Owe” campaign to elicit comments on the disclosures, and conducted extensive consumer testing prior to issuing the proposed combined disclosure.<sup>86</sup> The revised disclosure promises to be a major improvement over the prior disclosures and hopefully can guide consumers to more appropriate mortgage loans. One very striking feature of the proposed disclosure, at least to those schooled in the teachings of the Truth in Lending Act, is that the traditional unitary cost measure for consumer credit, the Annual Percentage Rate or APR,<sup>87</sup> will be relegated to page three of the disclosure, whereas it was formerly the most prominent feature of the TILA disclosure. The CFPB found that contrary to the hopes of the framers of TILA, most consumers still do not understand what the APR is. The agency also found that the APR has become a less accurate yardstick of mortgage costs due in part to the prevalence of adjustable rate mortgages and open-end home equity lines of credit, making it impossible to predict the actual cost of credit for these types of loans.<sup>88</sup> Thus, the new disclosure will put the “interest rate” on the first page rather than the APR.

In addition to improving the existing disclosures, the new legislation contains an array of substantive consumer protections for mortgage loan consumers in areas where disclosure and consumer choice alone were deemed insufficient. The CFPB is required to issue new regulations to implement these new requirements.<sup>89</sup> The main areas of substantive reform include:

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<sup>84</sup> 12 U.S.C.A. § 5532(f).

<sup>85</sup> Consumer Financial Protection Bureau, Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z), Proposed rule with request for public comment, 77 Fed. Reg. 51116 (August 23, 2012), available at <http://www.regulations.gov/#!documentDetail;D=CFPB-2012-0028-0001>.

<sup>86</sup> *Id.* See also [www.consumerfinance.gov/knowbeforeyouowe](http://www.consumerfinance.gov/knowbeforeyouowe).

<sup>87</sup> The regulation requires that the disclosure of the APR be accompanied by a brief description such as “the cost of your credit as a yearly rate.” 12 C.F.R. § 226.18(e) [12 C.F.R. § 1026.18(e)].

<sup>88</sup> Richard H. Thaler, *A Chance to Make Mortgage Shopping Easier*, The New York Times, Business Day (Aug. 18, 2012).

<sup>89</sup> 12 U.S.C.A. § 5538. Note that these provisions of the law do not go into effect until either January 21, 2013 or when the CFPB issues the relevant regulations, whichever comes first. Pub. L. 111-203, Sec. 1400(c), 124 Stat. 1376 (2010).

- Universal requirement of consumer “ability to repay” as a condition for all residential mortgages;<sup>90</sup>
- Creation of a “safe harbor” for creditors who offer “qualified mortgages” that have certain characteristics that are favorable to consumers;<sup>91</sup>
- Ban on mortgage brokers steering consumers into unfavorable loans and on accepting “yield spread premiums” as compensation;<sup>92</sup>
- Strict limits on prepayment penalties;<sup>93</sup>
- Ban on the financing of “single premium” credit insurance;<sup>94</sup>
- Prohibition on pre-dispute mandatory arbitration clauses in most dwelling-secured consumer loans;<sup>95</sup> and
- Imposition of “appraisal independence requirements” in all consumer credit transactions secured by the principal dwelling of the consumer.<sup>96</sup>

Highlights of the main substantive provisions of the Mortgage Reform Act are summarized below.<sup>97</sup>

First, the new law has an “ability to repay” requirement. Although one would think that creditors and consumers alike would naturally want to assure themselves that the borrower had the ability to repay their loans, this was not always the case. One of the practices that allegedly contributed to the foreclosure crisis was that banks and other institutions were lending to people who could not afford the loans they were being offered. Sometimes this practice stemmed from the idea of foreclosing if needed when there was a default, i.e., lending based on collateral. In other cases the improvident loan deals were fueled by unscrupulous brokers who may have encouraged

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<sup>90</sup> 15 U.S.C. §1639c(a)(1).

<sup>91</sup> 15 U.S.C. §1639c(b).

<sup>92</sup> 15 U.S.C. §1639b(c)(1). This prohibition on YSP was foreshadowed by a Federal Reserve Board regulation that contained a very similar provision. 12 C.F.R. § 226.36(d).

<sup>93</sup> 15 U.S.C. §1639c(c).

<sup>94</sup> 15 U.S.C. §1639c(d).

<sup>95</sup> 15 U.S.C. §1639c(e)(1).

<sup>96</sup> 15 U.S.C. §1639e.

<sup>97</sup> For a more complete description of all the provisions, see Dee Pridgen, *Putting Some Teeth in TILA, : From Disclosure to Substantive Regulation in the Mortgage Reform and Anti-Predatory Lending Act of 2010*, 24 LOY. CONSUMER L. REV. 615 (2012).

false or undocumented loan applications and inflated appraisals to increase their commissions and who then passed on the loans to lenders who would have to deal with the inevitable default. Also, when mortgages were sold to investors, via “securitization,” the originators could collect their fees and let the consumer worry about making payments or suffer foreclosure because the investors, protected by the “holder-in-due course doctrine,” did not bear much risk from whatever legal problems there were with the original loan.<sup>98</sup> Consumers also underestimated the risk of foreclosure due to the previously discussed “optimism” bias and other cognitive barriers.<sup>99</sup> Thus, the new law’s universal extension of an “ability to repay” requirement for residential mortgages is a big step forward for consumers. Mortgage lenders will have to engage in more responsible lending and will no longer be allowed to engage in asset-based lending that ignores the consequences of such practices on individual consumers.<sup>100</sup>

Second, related to the “ability to repay” requirement, is the provision of a “safe harbor” compliance alternative for lenders who might otherwise have to provide extensive documentation to prove that consumers have the ability to repay. If lenders offer a so-called “qualified mortgage” that has certain pro-consumer characteristics, they will be presumed to have complied with the “ability to repay” requirement.<sup>101</sup> This is an example of what behavioral economists might term “libertarian paternalism” whereby market participants are steered in welfare-promoting directions without removing freedom of choice.<sup>102</sup> In this case, the law tends to reward lenders who offer mortgages that contain better provisions for consumers, but neither the lender nor the consumer are limited to contracts with these

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<sup>98</sup> See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002). Of course, investors did bear the risk that the value of the securities would fall due to the underestimated risk of sudden, widespread foreclosures due to the collapse of the real estate market.

<sup>99</sup> See text accompanying notes 67-71, *supra*.

<sup>100</sup> John Pottow, *Ability to Pay*, 8 BERKELEY BUS. L.J. 175 (2011).

<sup>101</sup> 15 U.S.C. A. § 1639c(b). Qualified mortgage loans must have no negative amortization; no interest only payments; no balloon payments; fully amortized rates; documentation of consumer income and financial resources; creditor compliance with guidelines on debt-to-income ratios; total points and fees that do not exceed 3% of the total loan amount; and the term of the loan is not greater than 30 years. 15 U.S.C.A. § 1639c(b)(2).

<sup>102</sup> See generally Cass R. Sunstein and Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

terms. When lenders are steered toward these mortgages, consumers will also be likely to go along because most mortgage agreements are offered as standard form contracts in which it is highly unlikely that individual consumers would have any ability to negotiate their provisions.

Third, the Mortgage Reform Act will implement a ban on broker compensation via yield spread premiums, putting to rest a long standing controversy that had resulted in conflicting regulations under TILA and RESPA.<sup>103</sup> The yield spread premium (YSP) is a form of broker compensation in which fees are paid by the mortgage lender to the mortgage broker based on the difference between market or par rate, and the rate actually charged to the borrower.<sup>104</sup> The disadvantage to consumers of this form of compensation is that the consumer may not realize they could have gotten a loan with a lower interest rate by using a different broker or by negotiating an upfront fee for the broker instead of using YSP. The use of YSP as broker compensation rewards the broker for obtaining a higher interest rate loan, which seems like a perverse incentive, perhaps not in the consumer's best interest.<sup>105</sup> Also, the use of YSP as broker compensation made it very difficult for consumers to comparison shop for a mortgage broker based on fees because the YSP aspect is hidden within the higher interest rate. Prior attempts at disclosure of YSP only resulted in consumer confusion.<sup>106</sup> This is another example of a consumer issue with residential mortgage lending that required stronger measures than disclosure alone.

Fourth, the new legislation places strict limits on prepayment penalties. They are now limited in amount and duration, or banned altogether.<sup>107</sup> A prepayment penalty means the borrowers pay extra if they want to pay off the loan early, typically by re-financing or resale. The penalty is meant to

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<sup>103</sup> 24 C.F.R. § 3500.7, and 12 C.F.R. § 226.36(d) (the TILA regulation banning YSP had been scheduled to go into effect in April 2011).

<sup>104</sup> See *Schuetz v. Banc One Mortgage Corp.*, 292 F.3d 1004 (9<sup>th</sup> Cir. 2002), cert. denied 537 U.S. 1171 (2003), for a good factual example and explanation of yield spread premiums. Formerly, YSP was governed by both RESPA as a potential illegal kickback, and by TILA and Regulation Z, as a part of the credit cost of the loan that had to be disclosed.

<sup>105</sup> Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J. L. BUS. & FIN. 289 (2007).

<sup>106</sup> In a study commissioned by the Federal Reserve Board in 2008, consumers who read disclosures stating that mortgage brokers had a financial incentive to steer them to loans with higher interest rates, nonetheless persisted in their prior belief that brokers were working only in the best interest of the borrower, despite the contradictory information they had just read. Macro International, Inc., CONSUMER TESTING OF MORTGAGE BROKER DISCLOSURES (July 10, 2008), at 7-8 and 12, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20080714regzconstest.pdf>.

<sup>107</sup> 12 U.S.C.A. § 1639c(c)(1)-(4).

compensate the lender for the lost expected income on the loan that is not realized due to early payment.<sup>108</sup> Prepayment penalties, especially if they extend for long periods of time, however, tend to discourage people from paying off loans with unfavorable provisions by refinancing. While prepayment penalties should be factored in as a potential cost of a loan, many consumers do not do so because this is a long-term cost and is contingent on an uncertain future event. These types of costs are not noticed by the “myopic” consumer.<sup>109</sup> When such costs are not considered, however, a loan may appear to be cheaper than it really is. Thus, the prepayment penalty restrictions were needed to protect consumers from this type of hidden cost.

These and the other substantive guidelines for residential mortgage loans, as contained in the Mortgage Reform and Anti-Predatory Lending Act, represent the new direction in consumer protection. When it appears that disclosure alone will not protect consumers due to flaws in the individual decision making process, or creditor abuse of consumer weaknesses, as demonstrated by behavioral economics, the new law has stepped in with more direct measures. This same pattern also appeared in the earlier law governing credit cards.

## **B. Credit Cards**

Prior to the passage of the Credit CARD Act of 2009,<sup>110</sup> many consumers were plagued with large amounts of credit card debt. Congress found that part of the reason for this debt escalation was the fact that consumers were being “tricked and trapped” by various credit card practices, such as teaser rates, rate-jacking (unexpected rate increases after an account has been opened), late fees, penalty rates, over-the-limit fees, unfair billing practices and excessive marketing to young consumers, all of which made it difficult for consumers to manage their credit card accounts.<sup>111</sup> Basically this law amends TILA with specific substantive provisions designed to address the “tricks and traps” and other specific complaints from consumers about credit cards, although the law also initiated certain improvements in credit card disclosures as well. In doing so, Congress chose the path of imposing minimum substantive requirements

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<sup>108</sup> Linda Singer, Zachary Best & Nina Simon, *Breaking Down Financial Reform: A Summary of the Major Consumer Protection Portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 14 J. CONSUMER & COM. L. 2 (2010).

<sup>109</sup> Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 Cornell L. Rev. 1073, 1119-1121 (2009).

<sup>110</sup> Credit Card Accountability Responsibility and Disclosure Act [Credit CARD Act] of 2009, Pub. L. No. 111-24, 123 Stat. 1734, codified in scattered sections of 15 U.S.C.

<sup>111</sup> House Rep. 111-88 (April 27, 2009), Credit CARD Act of 2010.

in certain problem areas in lieu of the more traditional approach of relying solely on disclosure and rational consumer choice.<sup>112</sup>

The Credit CARD Act's substantive consumer protection provisions can be divided into four categories: provisions affecting rates; billing practices; fees; and protections for young consumers. The provisions affecting each of these aspects of credit cards are summarized below.

One of the biggest consumer complaints leading up to the CARD Act was the practice of credit card issuers unexpectedly increasing interest rates on balances.<sup>113</sup> These rate increases could be based on the unlimited "change of terms" clauses that appeared in most credit card contracts, "universal default" provisions that allowed creditors to increase rates based on a consumer's performance on other unrelated accounts, or due to "penalty" rates imposed for a series of late payments or default. Unexpected rate increases led to some consumers being unable to pay off their credit card debt. The CARD Act does not impose any ceiling on credit card interest rates, but it does limit certain practices associated with rate increases. These substantive limits include the following:

- Creditors must provide at least 45 days' notice of rate increases<sup>114</sup> and may not charge an increased rate to prior balances<sup>115</sup>;
- "Teaser" or promotional rates must last at least six months<sup>116</sup>;
- Creditors may not increase rates based on the consumer's payment pattern in connection with other accounts (universal default) unless they meet certain prerequisites<sup>117</sup>; and

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<sup>112</sup> Zachary J. Luck, *Bringing Change to Credit Cards: Did the Credit Card Act Create a New Era of Federal Credit Card Consumer Protection?*, 5 HARV. L. & POL'Y REV. 205 (2011).

<sup>113</sup> Adam J. Levitin, *Rate-Jacking: Risk-Based & Opportunistic Pricing in Credit Cards*, 2011 UTAH L. REV. 339 (2011).

<sup>114</sup> 15 U.S.C.A. § 1637(i)(1), (2). *See also* 12 C.F.R. § 226.9(c)(2)(i) [12 C.F.R. § 1026.9(c)(2)(i)]. Rates may be increased after the first year for new transactions, provided the 45-day advance notice requirement is complied with.

<sup>115</sup> 15 U.S.C.A. § 1666i-1(c)(1); 12 C.F.R. §§ 227.24(b)(3) [12 C.F.R. §§ 1027.24(b)(3)], 535.24(b)(3) and 706.24(b)(3).

<sup>116</sup> 15 U.S.C.A. § 1666i-2(b); 12 C.F.R. § 226.55 [12 C.F.R. § 1026.55].

<sup>117</sup> 15 U.S.C.A. § 1666i-1(a)-(b), banning rate increases except if the creditor provides a 45-day notice of the increase, a consumer right to cancel the account, and they do not apply the increased rate to previously accumulated balances. *See* 15 U.S.C.A. § 1637(i).

- If a rate is increased due to failure to receive the minimum payment within 60 days after the due date, the creditor must reinstate the prior rate if the creditor receives the minimum required payment for a period of six months.<sup>118</sup>

Credit card billing practices were another source of consumer complaints prior to the passage of the CARD Act. Consumers often seek to avoid finance charges by paying off their balances in full during the “free ride” period. Consumers also seek to avoid late fees by paying their bills on time. However, some creditors were known to apply a finance charge to prior balances if the full balance was not paid off in a given month, a practice known as “double cycle billing,” which eliminated the “free ride” period on the prior balance for those consumers. Also, due dates were variable, bills were mailed at such times that the “free ride” period was shortened, and the cut-off time on the due date to avoid late fees could be at an unexpected time of day, such as noon or early afternoon.<sup>119</sup> Different rates are often charged to different types of balances, such as cash advances versus purchases. Creditors in the past were known to apply payments first to the balance with a lower rate, leaving more in the high rate balance. In addition, credit card statements often encouraged, or at least did not discourage, the payment of the minimum payment amount, which had become increasingly small. Financially unsophisticated consumers often did not realize the consequences of paying only the minimum amount each month and carrying a balance, which usually resulted in payment over time of large amounts of finance charges.<sup>120</sup> The CARD Act attempts to address many of these issues regarding billing practices with the following provisions:

- Ban on “double-cycle billing,” a practice which had eliminated the “free ride” on prior balances if payment was not made in full by the due date<sup>121</sup>;
- Card issuers must apply the consumer’s payment first to balances with higher rates<sup>122</sup>;
- must mail bills 21 days before the due date<sup>123</sup>;

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<sup>118</sup> 15 U.S.C.A. § 1666i-1(b)(4).

<sup>119</sup> Norman I. Silber, *Late Charges, Regular Billing, and Reasonable Consumers: A Rationale for a Late Payment Act*, 83 CHI.-KENT L. REV. 855 (2008).

<sup>120</sup> Carolyn Carter, Elizabeth Renuart, Margot Saunders, & Chi Chi Wu, *The Credit Card Market and Regulation: In Need of Repair*, 10 N.C. BANKING INST. 23, 47 (2006).

<sup>121</sup> 15 U.S.C.A. § 1637(j); 12 C.F.R. §§ 227.25, 535.25, and 706.25.

<sup>122</sup> 15 U.S.C.A. § 1666v(b)(1); 12 C.F.R. § 226.53(a) [12 C.F.R. § 1026.53(a)].

- the due date must be same every month<sup>124</sup>;
- the cutoff time to avoid late payment on the due date must be 5PM<sup>125</sup>; and
- Card issuers must provide a minimum payment disclosure on the monthly statement showing payoff time and amount if only the minimum payment is made.<sup>126</sup>

Another common complaint of credit card consumers was that the fees being charged were unexpected, rigid, arbitrary, and seemed disproportionate to the transgression or to the cost imposed on the card issuer. For example, the same late fee was charged whether the payment was one day late or much later, and whether the balance was \$5 or \$500. “Back-end” credit card fees had become a large percentage of card issuer revenue in the lead-up to the financial crisis. Consumers, on the other hand, due to hyperbolic discounting, over-optimism, and a focus on salient features, failed to factor in the amount they were likely to pay in fees when comparison shopping for the best deal in credit cards.<sup>127</sup> Many consumers did not expect to be charged over-the-limit fees without being notified at the point of sale that their transaction was refused.<sup>128</sup> Other one-time or annual fees for subprime consumers were especially burdensome, sometimes leaving very little credit available for their use until the initial fees were paid.<sup>129</sup> Following are some of the provisions of the CARD Act that address the issues associated with credit card fees:

- Penalties and fees must be “reasonable and proportional” to the omission or violation for which they are imposed.<sup>130</sup> Under the relevant

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<sup>123</sup> 15 U.S.C.A. § 1666b(a) & (b); 12 C.F.R. § 226.5(b)(2)(ii) [12 C.F.R. § 1026.5(b)(2)(ii)].

<sup>124</sup> 15 U.S.C.A. § 1637(o); 12 C.F.R. § 226.10(d) [12 C.F.R. § 1026.10(d)].

<sup>125</sup> 15 U.S.C.A. § 1666c(a); 12 C.F.R. § 226.10(b)(2)(i) [12 C.F.R. § 1026.10(b)(2)(i)].

<sup>126</sup> 15 U.S.C.A. § 1637(b)(11); 12 C.F.R. § 226.7(b)(12) [12 C.F.R. § 1026.7(b)(12)].

<sup>127</sup> Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The CARD Act and Beyond*, 97 CORNELL L. REV. 967 (2012).

<sup>128</sup> *See, e.g.*, fact pattern in *Household Credit Services, Inc. v. Pfennig*, 541 U.S. 232 (2004) (holding that “over-the-limit” fees should not be considered a “finance charge” under TILA).

<sup>129</sup> *See, e.g.*, *Perry v. First Nat’l Bank*, 459 F.3d 816 (7<sup>th</sup> Cir. 2006).

<sup>130</sup> 15 U.S.C.A. § 1665d(a).

regulations, most late payment fees are limited to \$25 or \$35 and over-limit fees are capped at \$35.<sup>131</sup>

- Over-the-limit fees must be expressly elected by consumers to permit creditors to charge a fee to complete transactions involving the extension of credit in excess of the amount of authorized credit for the account being used.<sup>132</sup>
- Fees (other than late fees, over-the-limit fees, or fees for returned payments) cannot be more than 25% of available credit in the first 12 months (no “fee harvester” cards)<sup>133</sup>.

In passing the Credit CARD Act, Congress was particularly concerned about vulnerable consumers, such as college students, who were being bombarded with on-campus credit card marketing, only to wind up with large amounts of credit card debt they could not handle.<sup>134</sup> In response to these concerns, the Credit CARD Act contains a provision that prohibits the issuance of a credit card to consumers who are under 21 unless they have a co-signor who is twenty-one or older and is financially responsible, or unless the young consumer can show they have independent means of repaying the obligation.<sup>135</sup> This appears at first glance to be a rather extensive restriction on credit cards for young people. However, some have criticized the measure for not going far enough to protect young people.<sup>136</sup> The regulations implementing the statute say that the card issuer can look at the consumer’s ability to repay only the minimum payment, and can look to sources of income in the future, like seasonal work.<sup>137</sup> Thus, relatively under-employed college students under the age of 21 are still likely to be able to obtain credit cards, despite the provisions of the Act. Also, the co-signor provisions, while likely aimed at parents or guardians, actually allow slightly older college friends who are at least twenty-one, to co-sign for a

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<sup>131</sup> 12 C.F.R. § 226.52(b) [12 C.F.R. § 1026.52(b)].

<sup>132</sup> 15 U.S.C.A. § 1637(k)(1); 12 C.F.R. § 226.56 [12 C.F.R. § 1026.56].

<sup>133</sup> 15 U.S.C.A. § 1637(n); 12 C.F.R. § 226.52 [12 C.F.R. § 1026.52].

<sup>134</sup> See Creola Johnson, *Maxed Out College Students: A Call to Limit Credit Card Solicitations on College Campuses*, 8 N.Y.U.J. LEGIS. & PUB. POL’Y 191 (2004).

<sup>135</sup> 15 U.S.C.A. § 1637(c)(8); 12 C.F.R. 226.53(b) [12 C.F.R. § 1026.53(b)].

<sup>136</sup> Eboni S. Nelson, *From the Schoolhouse to the Poorhouse: The Credit CARD Act’s Failure to Adequately Protect Young Consumers*, 56 VILL. L. REV. 1 (2011).

<sup>137</sup> 12 C.F.R. § 226.51 [12 C.F.R. § 1026.51].

younger classmate, even though the co-signor may not be any more mature than the card applicant, and may end up saddled with their friend's improvident credit card debt.<sup>138</sup> Critics of the young consumer credit card protections say that these restrictions are contrary to the prevailing law of majority for most other contracts (set at 18), and will cut off an important source of credit for young entrepreneurs.<sup>139</sup> The current situation appears to be that it is more difficult for college-age consumers to obtain a credit card, but it is far from impossible.<sup>140</sup> Perhaps the added hurdles will inspire some caution on the part of young consumers. At least the days when students signed up for a credit card to get a free tee-shirt appear to be a thing of the past.

#### IV. Sea Changes in Consumer Financial Protection – Are They Good or Bad?

The sea changes in consumer protection law outlined in this article are not without critics, of course. Any new direction in public policy will be hotly debated. So what are the major arguments pro and con in this area? A brief overview follows.

One of the major arguments for basing consumer protection rules on rational consumer choice theory, rather than behavioral economics, is that both antitrust and consumer protection law should be based on the same consumer welfare theories. Rational consumer choice theory, which has long been the bedrock principle of antitrust, is itself based on the principle of consumer sovereignty where consumers' revealed preferences in the marketplace dictate policy.<sup>141</sup> Thus, in the model of perfect competition, informed consumers acting rationally in the marketplace, unhindered by market failures or anticompetitive conspiracies, will achieve allocative efficiency, such that the economy produces the goods consumers want at a

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<sup>138</sup> Dave Carpenter, Credit Cards and College Students Can Be a Dangerous Mix, USA Today Money (7/12/2012), available at <http://usatoday30.usatoday.com/money/perfi/college/story/2012-07-14/credit-cards-and-college-students/56170448/1?csp=34money&dlvrit=110940>.

<sup>139</sup> Andrew A. Schwartz, *Old Enough to Fight, Old Enough to Swipe: A Critique of the Infancy Rule in the Federal Credit CARD Act*, 2011 UTAH L. REV. 407.

<sup>140</sup> See survey results in Jim Hawkins, *The CARD Act on Campus*, 69 Wash. & Lee L. Rev. 1471 (2012).

<sup>141</sup> Joshua D. Wright, *The Antitrust/Consumer Protection Paradox: Two Policies At War with Each Other*, 121 Yale L.J. 2216 (2012). See also Neil W. Averitt & Robert H. Lande, *Consumer Choice: The Practical Reason for Both Antitrust and Consumer Protection Law*, 10 LOY. CONSUMER L. REV. 44 (1998).

competitive price.<sup>142</sup> The same theory carries over to consumer protection laws such as Truth in Lending, where the purpose of the law is to promote informed consumer choice in a competitive market for consumer credit, which in turn will maximize consumer welfare.

The use of behavioral economics, on the other hand, especially when it comes to providing a justification for specific substantive protections for consumers, arguably could mean that consumer choices are controlled more by the government and less by consumers themselves.<sup>143</sup> If consumers cannot for psychological/sociological reasons make self-interested rational choices in certain situations, then to protect them a third party (a legislature or government agency) may have to determine what is a rational choice for consumers and what is not. This could occur by regulations banning certain credit practices, such as the use of yield spread premiums for mortgage broker compensation, as opposed to simply warning consumers about the potential consequences but allowing such contracts to go forward. Or it could be a form of “nudge” or “debiasing” by which the regulatory provision requires that the default choice for the consumer is the one deemed most rational, while still allowing consumers to opt out and make a different choice should they so desire.<sup>144</sup> Some say this will result in the “nirvana fallacy,” i.e., the false idea that such third parties can in fact determine and promote the “true preferences” of consumers.<sup>145</sup> Others point out that government policy makers are also human and could themselves fall victim to behavioral biases, potentially undermining the rationality of the regulatory choices.<sup>146</sup> Still others call approaches based on behavioral economics the “new paternalism.”<sup>147</sup>

While to critics the ascendancy of behavioral economics as a basis for consumer protection policy may be cause for concern, to others this particular discipline seems more realistic than rational consumer choice theory as a basis for understanding marketplace behavior.<sup>148</sup> It also

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<sup>142</sup> ERNEST GELLHORN, WILLIAM E. KOVACIC, & STEPHEN CALKINS, *ANTITRUST LAW AND ECONOMICS IN A NUTSHELL* 67-73 (5<sup>th</sup> ed. 2004).

<sup>143</sup> Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. (forthcoming 2012), available at <http://ssrn.com/abstract=2147940>.

<sup>144</sup> Sunstein & Thaler, *supra* n. 102. See also RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH AND HAPPINESS* (2008).

<sup>145</sup> Joshua D. Wright, *supra* n. 141, at 2239-40.

<sup>146</sup> See Edward L. Glaeser, *Paternalism and Psychology*, 73 U. CHI. L. REV. 133 (2006).

<sup>147</sup> Matthew A. Edwards, *The FTC and New Paternalism*, 60 ADMIN. L. REV. 323, 325-328 (2008).

<sup>148</sup> Edward L. Rubin, *Rational Choice and Rat Choice: Some Thoughts on the Relationship Among Rationality, Markets, and Human Beings*, 80 CHI.-KENT L. REV. 1091

comports with everyday experience. The insights of behavioral economics also can be used to explain the failure of the disclosure regime of the Truth in Lending Act.<sup>149</sup> Why did consumers persist in signing residential mortgages that had unaffordable costs and unfavorable provisions that were clearly disclosed to them if consumers always act rationally in their own self-interest if provided with adequate information? Some of the phenomena discussed above, such as bounded rationality, myopia, optimism and trust of authority figures, concepts that have been associated with behavioral economics, can help explain this paradox.<sup>150</sup> The new approach to consumer protection also addresses the balance of power between consumers and marketers. Individual consumers are hampered by cognitive barriers on a daily basis in a wide variety of transactions, whereas marketers have the time and resources to study human behavior in a focused way and try to use what they learn to sell their products.<sup>151</sup> Note that both marketers and government regulators are indeed “human,” and subject to behavioral biases, but unlike consumers, the human marketers and regulators have the luxury that consumers do not have to take the time to study the market choices as well as the consumer behavioral data to support their actions. Finally, the application of behavioral economics does not mean that the reliance on competitive markets as the best way to promote consumer welfare has been abandoned. Rather, there has been a renewed recognition that when the competitive marketplace suffers from a lack of transparency and fairness, it will not fulfill its proper function. Thus, Congress charged the new CFPB to ensure that “all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”<sup>152</sup> Some new initiatives in consumer credit regulation also take the approach of “nudging” better choices, such as by establishing a “safe harbor” for mortgage lenders who offer consumers a “qualified mortgage,” rather than simply requiring all mortgages to have these provisions.<sup>153</sup> Rather than taking away consumers’ “liberty” to be victimized by unfair or deceptive creditor practices, these new laws, based in part on behavioral economics, allow competition to occur on a level playing field and with minimum rules

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(2005).

<sup>149</sup> Dee Pridgen, *Putting Some Teeth in TILA: From Disclosure to Substantive Regulation in the Mortgage Reform and Anti-Predatory Lending Act of 2010*, 24 LOY. CONSUMER L. REV. 615 (2012). See also Jean Braucher, *Form and Substance in Consumer Financial Protection*, *supra* n. 41.

<sup>150</sup> See text accompanying footnotes 67-78, *supra*.

<sup>151</sup> See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004).

<sup>152</sup> 12 U.S.C.A. § 5511(a).

<sup>153</sup> See text accompanying footnotes 101-102.

of safety and fairness.<sup>154</sup>

Another critique of the focus on specific creditor practices or contract clauses is that such an approach will be only a temporary fix and is doomed to fail in the long run. Once a specific practice is prohibited by law, it is posited that the market or the development of new technologies will devise a “work-around” that is not prohibited but that achieves the same result. For example, if creditor fee x is banned or limited, creditor fee y will replace it. This insight was part of the reason for endowing traditional consumer protection agencies, such as the FTC, with general authority over “unfair and deceptive trade practices,” so that new and unforeseen forms of consumer abuse can be dealt with as they arise. As stated in the House Conference Report on the original FTC Act:

It is impossible to frame definitions which embrace all unfair practices. There is no limit to human inventiveness in this field. Even if all known unfair practices were specifically defined and prohibited, it would be at once necessary to begin over again. If Congress were to adopt the method of definition, it would undertake an endless task.<sup>155</sup>

In setting up the CFPB, Congress gave the agency very specific mandates in some parts of the law, such as the Mortgage Reform Act, but also gave the agency authority over “unfair, deceptive or abusive” practices in the relevant financial sectors.<sup>156</sup> Thus there is the potential for the CFPB to address unforeseen consumer abuses that have not even been imagined at the time the law was written. This is particularly true with regard to the “abusive” practices standard, which allows the CFPB to regulate in instances where credit practice “materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service,” or where financial service providers “take unreasonable advantage of” the consumer’s lack of understanding or inability to protect their own interests.<sup>157</sup> One author has stated that the CFPB’s “anti-abuse regulation based on behavioral economics promises to be an important development, arguably the most significant innovation in consumer law in decades.”<sup>158</sup>

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<sup>154</sup> See Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008), originating the idea that consumer credit regulation should be more like other consumer product safety regulations, such as those governing the common toaster.

<sup>155</sup> H.R. Rep. No. 1142, 63<sup>rd</sup> Cong., 2d Sess. 19 (1914).

<sup>156</sup> 12 U.S.C.A. § 5511(b)(2).

<sup>157</sup> 12 U.S.C. § 5531. See also text accompanying footnotes 34-42, *supra*.

<sup>158</sup> Jean Braucher, *Form and Substance in Consumer Financial Protection*, *supra* n.

The new consumer protection legislation discussed here, like all new legislation, will involve some costs as well as benefits. The consumer credit market was already regulated prior to the new laws and the new agency and so the question is raised whether or not the costs outweigh the potential benefits. For better or worse, in order to achieve any benefit from new consumer protections, there will be costs imposed on the regulated parties and indirectly on society as a whole. In this case, the potential benefit to consumers in the form of protection from harmful choices is difficult to measure, because basically the benefit is in not doing something that might have been harmful. So it is akin to trying to prove a negative. The cost to creditors of new regulations, simply in terms of transition and compliance costs, on the other hand, is readily quantified by the regulated industry. The benefit/cost issue is a legitimate question, and the answer will not be known until the new regulatory wave is fully played out. Congress has arguably anticipated this issue by stipulating that the CFPB must conduct a cost-benefit analysis of the effects of any new rules on both consumers and creditors.<sup>159</sup> Any reduction in the likelihood of future financial crises would be a benefit worth some cost.

Another related criticism of the new consumer protection approach in the credit market is that these new laws will reduce the supply of consumer credit by raising costs to creditors who will in turn pass on these higher costs to consumers.<sup>160</sup> This fear of the high cost of compliance has inevitably accompanied any new initiative to protect consumers, but often proves to be exaggerated. For instance, in 1975 at a Congressional hearing to consider amending the Equal Credit Opportunity Act to require notices of reasons for adverse action, it was reported that Sears Roebuck & Company had estimated the cost for compliance would be approximately \$5 per letter. After the law was enacted, Sears reported to the Federal Reserve Board that the actual average cost of compliance with this particular requirement was 59 cents per letter.<sup>161</sup> More recently, the new consumer protection rules for credit cards contained in the CARD Act of 2009 were claimed to be likely to restrict access to consumer credit and raise its cost. A study by the

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41, at 4. Despite this broad grant of authority, however, the CFPB is constrained by the statutory definitions of these general terms, as well as indirectly by years of FTC precedent defining unfair and deceptive trade practices.

<sup>159</sup> 12 U.S.C.A. § 5512(b)(2).

<sup>160</sup> See David S. Evans & Joshua D. Wright, *The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit*, 22 LOY. CONSUMER L. REV. 277 (2010) (note that the analysis in this article was based on a 2009 Treasury Department proposal, whereas the Dodd-Frank Act that ultimately set up the CFPB contained some significant differences from that proposal).

<sup>161</sup> JOHN A. SPANOGLA, RALPH J. ROHNER, DEE PRIDGEN & JEFF SOVERN, CONSUMER LAW, CASES AND MATERIALS 396-97 (Thomson West 3d ed. 2007).

Center for Responsible Learning, however, showed that one year after the legislation went into effect, there was an increased transparency of credit card pricing, credit card prices remained level, and the supply of credit cards was not constricted.<sup>162</sup>

Some of these new laws will prevent some people from obtaining credit, who otherwise would have been able to do so. Indeed, there will soon be a duty imposed on lenders to assure a borrower's ability to repay in all residential mortgage loans<sup>163</sup> as well as credit card accounts.<sup>164</sup> The Credit CARD Act also bans the extension of credit in the form of credit cards to all consumers under the age of 21, subject to narrow exceptions that focus on their ability to repay.<sup>165</sup> These requirements, by definition, will eliminate some borrowers who might otherwise have been able to obtain loans, however improvident they might have been. The business community argues that they and individual consumers are in the best position to decide creditworthiness, without having to comply with government standards.<sup>166</sup> On the other hand, this denial of mortgages or credit cards to persons who lack the ability to pay for these items was deemed necessary to counteract the tidal wave of predatory lending that led up to the financial crisis.<sup>167</sup> Avoiding the improvident extension of credit to persons who lack the ability to repay can also protect society and the economy as a whole. It is well known that an increase in the financial distress of consumers can have effects not only on the individual or individuals immediately involved, but also on their family, their neighborhood (foreclosure blight), and their creditors (assuming bankruptcy or default). Indeed, it could be argued that improvident lending brought down the U.S. economy and led to the Great Recession of 2008.

Finally, critics of the CFPB are concerned that the new agency is not only strong but perhaps too strong, that it lacks sufficient Congressional oversight and has too broad a mandate. Some may favor the more traditional independent regulatory commission structure of the Federal Trade Commission, which is more directly controlled by Congress, rather than the relatively independent CFPB structure. Many are fearful of the potential flood of new federal regulation that may be heading toward the consumer financial sector as a result of the Dodd-Frank Act.<sup>168</sup> Players in

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<sup>162</sup> Joshua M. Frank, Center for Responsible Lending, *Credit Card Clarity: CARD Act Reform Works* (February 16, 2011), available at [www.responsiblelending.org](http://www.responsiblelending.org).

<sup>163</sup> 15 U.S.C.A. § 1639c(a)(1).

<sup>164</sup> 15 U.S.C.A. § 1665e.

<sup>165</sup> 15 U.S.C.A. § 1637(c)(8)(A)-(B).

<sup>166</sup> Manley Williams and Sara E. Emley, *CARD Act's Ability to Pay Proposal Ignites Public Policy Debate*, 60 AM. U. L. REV. 1417, 1427-1429 (2011).

<sup>167</sup> John Pottow, *Ability to Pay*, 8 BERKELEY BUS. L.J. 175, 205-208 (2011).

<sup>168</sup> Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett, & Arthur B. Axelson,

the fringe banking sectors like payday lending, pawn broking and automobile title lenders will be subject to federal regulation for the first time.<sup>169</sup> Giving the CFPB authority not only over unfair and deceptive consumer credit practices, but also over “abusive” practices is also a point of concern because this is uncharted water for consumer financial regulation.<sup>170</sup>

Despite the misgivings of some, it is clear that the creation of the CFPB was necessary to provide more effective consumer protection. The legislative blueprint for the CFPB has succeeded in uniting the previously balkanized regulation of the consumer financial sector by consolidating functions that were spread out over the bank regulatory agencies and the FTC.<sup>171</sup> This change alone eliminated the prior issues of conflicted missions, lack of focus and regulated entities shopping for favorable regulators. Also, although the CFPB is not directly funded by Congress, the Bureau must be audited annually by the Comptroller General, and the director must submit an annual report to Congress on its operations.<sup>172</sup> This seems like a reasonable compromise between the situation of an agency like the FTC, which can be effectively muzzled by political pressure, and a completely unaccountable agency (which the CFPB is not). Placing non-bank “fringe” providers under some federal supervision is not simply gratuitous regulation. This sector deals with the financially vulnerable and the industry players were not constrained in the same ways as their counterparts in the banking industry. Thus, extending regulation to this sector may mean more uniform rules for credit products, regardless of their source. Finally, the extension of authority to “abusive” practices was necessary to address marketing practices that exploit consumer weakness, and that were not adequately remedied by disclosure along. Nonetheless, it

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*Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform under the Dodd-Frank Act*, 66 BUS. LAW. 457, 472 (2011).

<sup>169</sup> See Jim Hawkins, *Regulating on the Fringe: Reexamining the Link between Fringe Banking and Financial Distress*, 86 IND. L.J. 1361, 1380-1382 (2011); Michael B. Mierzewski, Beth S. DeSimone, Jeremy W. Hochberg, and Brian P. Larkin, *The Dodd-Frank Act Establishes the Bureau of Consumer Financial Protection as the Primary Regulator of Consumer Financial Products and Services*, 127 BANKING L.J. 722, 735-36 (2010).

<sup>170</sup> See David S. Evans & Joshua D. Wright, *The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit*, 22 LOY. CONSUMER L. REV. 277 (2010); Tiffany S. Lee, *No More Abuse: The Dodd-Frank and Consumer Financial Protection Act's “Abusive” Standard*, 14 J. CONSUMER & COMMERCIAL LAW 118, 119 (2011).

<sup>171</sup> Leonard J. Kennedy, Patricia A. McCoy and Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 CORNELL L. REV. 1141 (2012).

<sup>172</sup> 12 U.S.C.A. § 5487(a)(5) and (e)(4).

is not an unlimited grant of power. The statute contains a specific definition of “abusive,” that focuses on practices that interfere with the ability of consumers to understand the terms and conditions they are being offered, or that take unreasonable advantage of the consumer’s lack of understanding, inability to protect their own interests, or reasonable reliance on a trusted advisor.<sup>173</sup>

## V. Conclusion

These are indeed exciting and turbulent times for consumer protection law. With the creation of the new Consumer Financial Protection Bureau and associated changes in the substance of federal consumer credit laws, the field is undergoing “sea-changes” that will play out for years to come. The new agency was established to unite the previously diffuse regulation of providers in the consumer financial services sector, changing from shared authority among the Federal Reserve Board, other bank regulatory agencies, and the FTC, to regulation under a single authority. The CFPB was set up in a way that gives it the potential to be more powerful and more effective than its older predecessor in the federal consumer protection arena, the FTC, because it has a single director not a Commission, with funding from the Federal Reserve System not Congress, and has authority to police unfair, deceptive and abusive consumer financial practices. At the same time, the law that created the CFPB also gives states more of an ability to raise the level of consumer protection by sharply curbing the federal preemption power, which had previously been used to prevent states from reacting to predatory lending abuses without any corresponding federal regulations.

This new approach to consumer protection embodied in the CFPB itself and in the new legislation that it will administer, is widely understood to owe its theoretical foundation to the field known as “behavioral economics.” This body of scholarship points out that contrary to the teachings of classical economics, the average consumer does not always act as “homo economicus,” making rational choices to maximize individual welfare in all transactions. Behavioral economics has forwarded the seemingly common sense insight that consumers can be pushed toward irrational marketplace choices by the exploitation of certain cognitive barriers that we all experience. This perceived consumer irrationality does not mean that all consumers act irrationally in all their choices. Nor does the new approach to consumer protection mean that we are doomed to exist in a world where self-righteous government bureaucrats dole out “plain vanilla” goods that they think are best for the population. On the contrary,

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<sup>173</sup> 12 U.S.C.A. § 5531(d).

behavioral economics simply points out that certain types of market practices or manipulations tend to block rational consumer choice in certain situations. One insight of behavioral economics is that sometimes pure information may not be enough to protect consumers, due to the circumstances in which the consumer choice is being made. Thus, laws that attempt to eliminate specific distorting or exploiting practices, or that use pro-consumer defaults or other forms of “soft paternalism” to “nudge” consumers to better choices, will assist consumers in making rational choices in the marketplace. The “sea change” in consumer protection, as fundamental as it is, does not in the end eliminate free consumer choice in a free market. It simply recognizes the practical limits and the artificiality of putting all the responsibility for consumer protection on individual consumers. The government and the financial service providers must also do their part.