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CHAPTER 12
Market-Reinforcing versus Market-Replacing Consumer Finance Regulation

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The run-up to and aftermath of the financial crisis that began around 2008 produced a wave of new consumer financial protection regulations and institutions unique in recent American history in terms of their combined impact on consumers and the economy. From credit cards and mortgages to payday loans and debt collectors, the regulatory regime that came into being in the wake of the financial crisis has directly impacted every corner of consumer financial services and indirectly impacted millions of small businesses that rely on their founders' personal credit for financing.

But while the details of the current wave of regulatory institutions and initiatives created in the postcrisis era are new, the ideas that underlie them are not. Indeed, the most recent wave of regulation is just the latest in the cycle of history of the regulation of consumer credit in the United States. Command-and-control regulation of consumer finance from prior eras was abandoned when economists and policymakers came to realize that those regulations tended to harm those they were purportedly intended to benefit. In the short time since the financial crisis, the new regulatory regime is already having the same effect. Regulation has dried up access to financial services for millions of low-income Americans, driving them out of the mainstream financial system and into less-preferred alternatives. While the particular initiatives and institutions have changed, the underlying economics of consumer credit and its regulation have not. Thus, there is no reason to believe that the end results of this episode of regulation will be any different from those in the past—higher prices, less innovation, less competition, and worse outcomes for consumers.

The lessons of history suggest that the command-and-control regulatory approach of the postcrisis era is likely doomed to failure as its negative consequences for consumers and the economy come to be better understood. But this collapse of old-style regulation also presents an opportunity for a new, modern approach to consumer financial protection to take its place. Developments in technology have transformed consumer finance, from credit cards to payday loans to debt collection practices, making consumer products safer, more secure, more convenient, and more innovative than ever before. In recent decades, consumer finance has exploded as a national market and consumers have come to expect twenty-four-hour, instantaneous, secure access to bank accounts and credit anywhere in the world (even the most remote areas), on demand. Yet today's regulators persist in trying to impose an early-twentieth-century regulatory mindset on this flourishing Internet-age consumer finance system.

This chapter offers a new way forward. The premise is that the basic mindset that has characterized the postcrisis era is little more than new wine in old wineskins—the basic ideas have been tried, and failed, before. And from those failures it is possible to anticipate why they are unlikely to be more successful this time than in the past. At the same time, developments in technology and market competition provide a greater opportunity than ever to construct a regulatory regime that will serve consumers and the economy, promoting choice, competition, and innovation.

I will distinguish between two basic regulatory approaches to consumer credit: "market-replacing" regulation, on one hand, versus "market-reinforcing" regulation, on the other. Market-replacing regulatory strategies seek to limit choice and competition through prohibitions or restrictions on particular products and terms, such as price controls on interest rates (known as usury regulations) or de facto or de jure bans on particular products such as payday loans or bank deposit advance products. Market-replacing regulations are characterized by a decision by regulators or legislatures to replace the terms to which the parties would voluntarily bargain with terms dictated by the regulator, and to prohibit consumers from entering into certain contracts even if those consumers believe that purchasing that product furthers their own goals. A market-reinforcing regulatory strategy, by contrast, seeks to promote competition and choice so that consumers can find those products that they think are best for themselves and their families. Whereas market-replacing regulation limits the range of choices available to consumers or favors some options over others, market-reinforcing regulation generally assumes that individual choice is a given and consumers generally know their personal needs better than regulators, so it seeks to promote innovation and consumer choice in order to facilitate discovery of those products that best suit consumers' needs.[1]

WHAT IS THE CURRENT REGULATORY APPROACH?

The history of the regulation of consumer credit has been dominated by the market-replacing approach. While the use of credit is ancient (it appears that credit was used extensively in early agricultural settlements, for example, to deal with the seasonal nature of farming), regulation of credit is ancient as well. Laws (both political and religious) date back to at least the Code of Hammurabi (1750 BC), which limited interest charges to 33.3 percent on loans of grain repayable in-kind and 20 percent on loans of silver.[2] While the Code of Hammurabi appears to be the first recorded evidence of interest rate price controls it certainly was not the last—since that time, market-replacing regulation, usually in the form of interest rate ceilings, has been ubiquitous, including for most of the history of the United States.

The Long History of Substantive Regulation

Several arguments have been advanced over time to support interest rate ceilings and prohibitions or limits on other terms.[3] In general, however, they boil down to two basic arguments. First, consumer credit contracts are "contracts of adhesion" in which a lender is posited to have monopoly power and the consumer, with unequal bargaining power, is "forced" into the terms of the contract on a "take it or leave it" basis. This is especially the case for avowedly unsophisticated or desperate parties who are thought to be particularly prone to exploitation. For example, in earlier eras, supporters of regulation argued that retailers preyed on "math-impaired females," who supposedly were unable to understand the full cost of the credit that they were using. Second, consumers are thought to lack self-control and be able to be "goaded" into purchasing products that they cannot afford and thus use credit to try to live beyond their means. For example, the theory of "conspicuous consumption" developed by economist Thorsten Veblen in the nineteenth century pointed to consumer credit as one of the drivers of the conspicuous consumption race. Today, the modern theories of behavioral economics have been used to update this argument, drawing on purported biases such as the problem of "hyperbolic discounting" or other cognitive biases that lead consumers to spend excessively today and to therefore save insufficient amounts of money for the future.

Although frequently used interchangeably as rationales for regulation, these two theories generate different predictions about the patterns of the supply and demand of consumer credit. Under the first rationale, regulation is seen as a mechanism for constraining purported monopoly power by lenders that can enable lenders to extract monopoly rents from consumers. In that case, regulation is seen as a way of reducing prices to consumers, but it is thought that there would be little or no restriction in the supply of credit made available to consumers. Under the second theory, however, it is anticipated that usury restrictions will in fact have the effect of reducing the availability of certain high-cost credit products. In some instances this is seen as a desired effect, as restricting access to high-cost credit is a way of protecting poor consumers from exploitation by so-called predatory lenders offering high-cost credit products.

Economic analysis has rejected the first hypothesis that consumer lenders exercise monopoly power over borrowers and thus can dictate the terms of consumer credit, including interest rates.[4] The real interest rates on consumer credit are set by market forces of supply and demand, not by regulation. Thus, contrary to that theory, unregulated interest rates do *not* tend to rise to the maximum rate permitted by law (unless the maximum rate is set very low), but instead are readily explicable by standard economic forces such as default risk, cost of funds, and other costs of operations.[5] Where usury ceilings are binding, by contrast, higher-risk borrowers are typically rationed out of the market, which suggests that there are real economic effects from imposing a price ceiling at a rate below the equilibrium price.[6] There is also no evidence that lenders earn permanent monopoly returns on consumer credit operations where entry is allowed, although certain types of regulation can artificially segment markets and dampen competition among providers.[7]

Interest rate ceilings are binding, however, when the market price of credit as established by the forces of supply and demand exceeds the statutorily permitted interest rate ceiling. A detailed discussion of interest rate ceilings and their impact is presented in chapter 13. For current purposes, however, usury laws provide a prototypical example of market-replacing regulation that can be applied to any regulation of specific terms of consumer loan contracts. Thus, economic studies of usury regulations are relied on here to illustrate the nature of market-replacing regulation and why this long-standing approach to regulation fell into intellectual disrepute until reinvigorated by the postcrisis regulatory environment.

Market-replacing substantive regulations of terms and products will have their intended effect but will also have several unintended consequences. The intended effects are usually easy to predict: if interest rates are capped at a certain rate—say, 10 percent—then lenders subject to the law cannot legally lend at a rate above 10 percent.

On the other hand, for lenders to be willing to make a loan, they must be able to do two things—to accurately set the price and other terms to reflect the predicted riskiness of the loan, and if they cannot, to reduce their risk exposure by either making loans to fewer people (especially excluding higher-risk borrowers) or by lending less to the same people (such as by reducing credit lines). Unintended consequences of the regulation of consumer credit can have three basic effects and frequently a fourth effect: (1) term repricing, (2) product substitution, (3) rationing, and in many cases (4) dynamic competitive effects. Consider each in turn.

First, term repricing (sometimes called "circumvention") describes the process by which borrowers and lenders agree to adjust some terms of the contract to offset the regulations on other terms of the contract in order to make the loan feasible. Because the price of a consumer loan is set by supply and demand, politicians cannot change the total price of a loan, just the combination of price and nonprice terms. For example, in the high-interest rate periods of the 1970s, when usury ceilings on credit cards were binding constraints, card issuers imposed annual fees on credit cards to make up for the inability to charge a market rate of interest on credit card loans. Thus, unsurprisingly, when credit card interest rates were effectively deregulated by the Supreme Court's decision in Marquette National Bank v. First of Omaha Service Corporation,[8] interest rates were permitted to be set at market rates and annual fees for standard credit cards quickly disappeared.[9] For loans other than credit cards, where interest rates are subject to binding interest rate caps, other terms of the contract may also be adjusted, such as requiring a higher down payment, artificially extending the maturity of the loan, requiring the borrower to post collateral, or requiring the borrower to borrow a greater sum of money so as to reduce the measured interest rate on the loan. Thus, while a borrower who receives a loan does so at a lower interest rate than would otherwise be the case, she will likely confront other less-desirable terms on other elements of the loan, such as being forced to borrow more money than she desires, thereby increasing her risk of default. Moreover, the effect is not limited just to interest rates—for example, when useful debt-collection remedies are restricted, which will increase the risk of lending and the expected loss rate on loans, lenders will offset that heightened risk by increasing interest rates, down payments, and other terms to compensate for the increased risk of loss. The effect of term repricing, therefore, will be to limit the stated price of the loan to the borrower but it will not affect the total cost of the loan to the borrower, as other terms of the loan will be adjusted to offset the parties' inability to contract for their preferred terms with respect to interest rates, down payments, loan size, and so on.

Second, if the borrower and lender are unable to effectively reprice the terms of the loan to offset the inability to contract at their preferred terms, some borrowers will be unable to obtain their preferred types of credit and will be forced to use alternatives, an adjustment known as "product substitution." Thus, for example, when strict regulation of credit card interest rates made it impossible for many consumers to acquire general-purpose bank-type cards and other unsecured credit, borrowers and lenders substituted and made greater use of other types of products instead, such as pawn shops and retail store credit. In many states, pawn shops traditionally have been regulated under a different set of rules than unsecured credit that often permit pawnbrokers to charge higher rates of interest. Thus, consumers who could not be approved for credit cards or could not gain a sufficient line of credit to meet their needs instead turned to pawnbrokers to fill the gap. Moreover, whereas credit card issuers could impose annual fees on credit cards to make up for their losses, pawnbrokers could reduce the amount they agreed to pay for pawned goods, thereby providing a more effective means of circumventing usury limits (where applicable). Department stores were also barred by usury ceilings from charging high prices on their credit programs, thus they typically ran their credit operations at a loss to subsidize their retail operations. But they were able to recoup those losses by raising the price of the goods that they sold, especially items such as appliances, which were typically sold on credit, thereby giving them a comparative advantage in circumventing usury limits.[10] For example, according to a 1979 study by economists William Dunkelberg and Robin De Magistris, in states with very low usury ceilings (Arkansas in their case) retailers originated a much larger percentage of consumer credit transactions (as opposed to banks and finance companies) than in states with less-restrictive usury ceilings.[11] Thus, because some providers of credit (such as pawnbrokers and retailers) either were not bound by the same usury ceiling or were able to evade usury restrictions more easily than others (such as credit card issuers) consumers would substitute those alternative types of credit for their preferred types of credit.

Third, even after these other adjustments, some consumers would find themselves unable to obtain legal credit on any terms. This led to the problem of credit-rationing—not being able to obtain legal credit at all. Reducing the supply of credit, however, did not eliminate the demand, especially for higher-risk borrowers. Thus, where consumer credit regulations were most severe, illegal loan sharks arose to meet that demand.[12] Even if consumers do not turn to loan sharks, however, they will still face the hardship associated with lack of access to financial services—bounced checks, late bill payments, lack of wealth-building potential, and the inability to acquire goods and services that can improve their lives.

Fourth, by prompting all of these adjustments in response to the distorting effects of substantive restrictions on lending terms, the total effect of usury restrictions was to make the terms of consumer credit products more complicated and less transparent. As a result, it became more difficult for consumers to compare across products and balkanized markets by erecting a series of ad hoc regulations designed to address particular evasions that arose with respect to particular products. Consider, for example, the practice of charging an annual fee on a credit card as a response to the inability to charge a market rate of interest. Not only does that substitution make both the borrower and lender worse off by forcing them to depart from their preferred set of lending terms, the presence of an annual fee functions as a sort of "tax" on holding a credit card. Thus, rather than a consumer holding several credit cards at any given time that are all competing for his business, if he is required to pay an annual fee he is likely to only carry one credit card and consider switching each year only at the time the annual fee is to be paid.

Similarly, by reducing the comparative advantage of retailers in engaging in term repricing behavior through raising the price of the goods that they sell, deregulation of consumer credit terms also eliminated the competitive advantage that large department stores held over smaller retailers because of their superior ability to bear the cost and risk of maintaining an in-house credit operation.[13] Deregulation of interest rates, therefore, not only prompted greater competition in consumer credit markets but in retail markets as well, enabling smaller (and eventually online) retailers to compete directly with large department stores without having to maintain costly credit operations.

Finally, although these regulations usually were supposedly intended to benefit low-income people, they invariably had a regressive distributional effect. For example, to the extent that interest rate ceilings rationed some people out of the market for legal credit, it was the higher-risk borrowers—who are disproportionately younger and have lower incomes—who were excluded. Indeed, by drying up the supply of lending capital to higher-risk borrowers, usury restrictions might have actually diverted capital to lower-risk markets, resulting in a higher supply and lower prices for middle- and high-income borrowers at the expense of low-income borrowers.[14]

The Rise of Disclosure Regulation

Over time, therefore, a consensus emerged that the costs of substantive, market-replacing regulation—especially the recurrent dangers of loan-sharking—exceeded the benefits to consumers and the market.[15] Thus, beginning in the 1960s, economists and regulators began to consider a different approach to consumer credit regulation—disclosure-based regulation. As first embodied in the Truth in Lending Act (TILA), disclosure-based regulation was an effort to implement a market-reinforcing approach to consumer credit regulation.[16] Rather than fixing prices or other terms of consumer credit contracts, the architects of TILA sought to harness the beneficial effects of market competition for the benefit of consumers. Rather than paternalistically seeking to protect consumers from themselves, TILA largely rested on the idea that individuals were the best judge of their own needs, preferences, and circumstances and that the most effective use of regulation would be to facilitate the provision of information from competing lenders in standardized and simplified formats that will enable consumers to compare competing credit offers.

More recently, however, this view of TILA has been eroded through excessive disclosure as the result of litigation and regulations that have piled more and more disclosures on consumers.[17] Consumers today are overwhelmed by pages and pages of disclosures mandated by regulation or provided defensively out of fear of litigation for failure to disclose a salient term. In addition, disclosures suffer from the creep of substantive regulation into disclosure regulation—a sort of "normative disclosure" whereby politicians and regulators require disclosure of terms that they believe consumers *should* care about, even if they do not.[18] "Normative disclosure" reflects a temptation to try to mold consumer decision-making through the use of disclosures, rather than heavy-handed substantive regulation. In so doing, however, regulators have stripped away the focus of the original market-reinforcing goal of TILA, producing a jumble of disclosure and substantive regulation.

Consider, for example, the requirement that each credit card statement prominently include a calculation of how long it would take consumers to pay off their credit card balance if they make only the minimum monthly payment. Providing this information to consumers in the form of a mandatory disclosure in every monthly statement is expensive for both card issuers and consumers—given the limited space and attention span available for consumers, there are myriad different pieces of information that an issuer could provide in that prominent location on the consumer's statement each month that instead is occupied with a particular disclosure. Yet based on research by former Federal Reserve economist Thomas Durkin, it appears that no more than 4 percent of consumers would find that information to actually be useful to their behavior, as that represents the percentage of consumers who would consider paying off their credit cards by making only the minimum monthly payment and, importantly, would also be willing to stop using the credit card while paying off the balance (because any new charges would, of course, change the payoff time).[19] Given the low percentage of consumers who actually care about this piece of information, the requirement that it be disclosed each month on every cardholder's statement more likely reflects the political sense of what consumers *should* care about and an effort to try to shape consumer behavior, rather than simply trying to provide consumers with the terms and information that they need in order to make their decisions.

WHAT IS WRONG WITH THE CURRENT APPROACH?

The period since the financial crisis has witnessed a resurgence of a belief in substantive, market-replacing regulation, as regulators have begun to again dictate terms and to prohibit certain terms and products. And, unfortunately, as they resuscitate discredited regulatory strategies, they are again reaping the predictable sorrows that invariably follow in their wake.

Consider the effect of recent restrictions on credit card pricing. In May 2008, the Federal Reserve Board proposed new rules that regulated credit card contract terms; the rules became final in December 2008, although those new rules were not scheduled to go into effect until July 1, 2010. In 2009, however, the US Congress passed the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the CARD Act),[20] which legislated many of the terms of the Fed's regulation, thereby superseding the Fed's action. In August 2010 the Federal Reserve issued its rules implementing the CARD Act. Thus, even though the final regulations were not implemented until August 2010, banks were aware by May 2008 at the latest (and presumably by 2007 or early 2008) of pending regulation governing credit card terms.

Both the Federal Reserve's regulations and the CARD Act significantly limit the flexibility of credit card issuers to adjust the terms of the agreement when a consumer's risk changes. For example, except for introductory rates and variable rate cards, issuers are required to provide forty-five days' notice before increasing interest rates and fees and are prohibited from increasing interest rates on existing balances unless the account falls deeply in arrears. Moreover, such rate increases must be reevaluated every six months. The rules also limit the size of the fees that can be assessed relative to the issuer's cost. These provisions limit the ability to adjust card pricing based on a consumer's observed risk.

As expected, the Federal Reserve's regulations and the CARD Act did in fact have the intended effect of limiting the size of the fees that were subjected to new regulation under the law.[21] But analysis has also generally found that interest rates, annual fees, and other fees (such as cash-advance fees) increased after the Federal Reserve regulations and CARD Act went into effect. In addition, the introduction of new rules that limited the ability to engage in risk-based pricing had the expected effect of reducing access to credit card credit, both by reducing total credit lines outstanding but, even more, reducing access to credit cards for lower-income (and generally higher-risk) borrowers. In turn, those who lost access to credit cards presumably had to turn to alternative types of credit that are more expensive, such as payday loans, personal installment loans, or other types of credit. Thus while some consumers benefited as a result of the CARD Act—namely, those who otherwise would have paid fees for exceeding their credit limits or incurring other fees—other consumers were harmed by paying higher interest rates or higher annual fees or by losing access to credit cards altogether and being forced to turn to alternative, more expensive credit.

A second example of the negative unintended consequences of the current regulatory approach is the effects of the so-called Durbin Amendment to Dodd-Frank Wall Street Reform and Consumer Protection Act, which imposed price controls on the interchange fees that could be charged on debit cards issued by larger banks (with more than $10 billion in assets).[22] Interchange fees are part of the "merchant discount" fee that is paid by merchants when they accept a payment card to complete a transaction to compensate the bank issuing the card to the consumer. Prior to Dodd-Frank, interchange fees on debit cards were set by market forces. The result was that debit cards rapidly became one of the most popular and quickly adopted consumer banking innovations in American history.

Debit card usage soared during the decade of the 2000s, rapidly displacing checks in terms of consumer (and merchant) popularity and passing credit cards as well by mid-decade.[23] Perhaps more important, as a result of the growing popularity of debit cards and the interchange fee revenues they generated, banks were able to extend to consumers greater access to free checking accounts, to reduce other bank fees and the minimum balances necessary to gain access to free checking, and to make major quality investments in retail banking services such as the development of online and mobile banking products. Between 2001 and 2009, for example, access to free checking rose dramatically, from less than 10 percent of all bank accounts to 76 percent of all bank accounts. In turn, this expansion of access to free checking expanded financial inclusion, bringing into the mainstream financial system millions of consumers who historically had been unable to afford a bank account.

The imposition of the Durbin Amendment, however, reversed these trends, with particularly harsh consequences for low-income consumers. The Durbin Amendment provided that any interchange fee for a debit card issued by a covered bank is required to be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" plus a small addition for fraud losses. The primary effect of the rule, therefore, is to permit issuers to recover interchange fees tied to consumer transactions but not to enable recovery of fixed and other operating costs, such as the cost of acquiring consumers, bank branches, customer service, or card issuance. As implemented by the subsequent Federal Reserve rulemaking, the end effect of the Durbin Amendment was to cut the interchange fee per transaction approximately in half with an estimated total loss of $8.5 billion in annual interchange fee revenue.[24]

The Durbin Amendment had its intended effect of reducing the interchange fees paid by merchants who choose to accept payment cards by billions of dollars annually, but the bulk of the savings flowed to very large merchants, such as big-box retailers, department stores, and Amazon.com. In fact, there is no evidence that small and medium-sized merchants experienced any savings in the period following the Durbin Amendment, and many merchants who process many small-dollar transactions actually experienced an increase in the size of the fees that they paid. But while the Durbin Amendment reduced the amount paid by merchants to support the payment card network, those costs did not disappear. Instead, they were simply shifted in the first instance over to card issuers and then, as would be predicted in a highly competitive market such as retail banking, on to consumers.

A study by Zywicki, Manne, and Morris on the effects of the Durbin Amendment found that while the per-transaction and total interchange fees paid by merchants declined following the Durbin Amendment's enactment, those revenue losses were simply shifted on to consumers in the form of higher bank fees and loss of access to free checking.[25] Access to free checking fell from 76 percent of bank accounts in the immediate pre-Durbin period (2009) to only 38 percent by 2013. Moreover, this decline in free checking was experienced *only* at larger banks subjected to the Durbin Amendment—smaller banks did not reduce access to free checking and may have actually increased it (by some measures). In addition, monthly maintenance fees for non-free checking accounts increased dramatically, and did so in the period immediately following the enactment of the Durbin Amendment. Other bank fees and the mandatory minimum balance necessary to gain access to free checking rose dramatically as well.

Most tragic, the higher bank fees and reduced access to free checking caused by the Durbin Amendment reversed many of the gains in access to bank accounts experienced by low-income consumers in the preceding decade. According to the Federal Deposit Insurance Corporation, between 2009 and 2011 the number of unbanked consumers increased by one million.[26] While a number of factors might have contributed to this increase in the number of unbanked households, the increase in bank fees and loss of free checking caused by the Durbin Amendment presumably contributed. Moreover, because of the increase in the minimum balances necessary to maintain free checking, many low-income consumers who maintained bank accounts were now forced to pay monthly maintenance fees or saw the size of those and other fees increase. In addition, banks terminated rewards programs and other perks offered on debit cards, thereby reducing their quality and attractiveness to consumers.

At the same time, while large merchants saved billions of dollars as a result of the Durbin Amendment, there is no evidence that any of these cost savings were passed through to consumers in the form of lower prices or higher quality. As a result, Zywicki, Manne, and Morris estimate that the overall effect of the Durbin Amendment is a wealth transfer of approximately $1 billion to $3 billion per year to large retailers and their shareholders. Moreover, these costs were almost entirely regressive—higher-income consumers were either able to avoid the impact of higher bank fees by increasing the size of their minimum balances or using other bank services or simply shifted their purchase volume from debit cards to credit cards, for which interchange fees remained unregulated and for which rewards remained in effect.[27]

As these examples illustrate, the trend in recent years back toward market-replacing regulation in the form of the substantive regulation of the terms and conditions of consumer credit products is having effects identical to past efforts. Regulation of some terms, such as the ability to adjust interest rates or fees on credit cards in response to changing consumer risk, simply led to the repricing of other fees, such as higher interest rates for all consumers. In addition, interfering with the ability to price risk efficiently has led to a reduction in access to credit cards, especially for low-income consumers, forcing them to substitute and to rely more heavily on alternative products such as payday lending that are typically more expensive and less preferred by consumers. Finally, to the extent that regulators are increasingly taking away access to those products, such as by restricting access to payday loans, this in turn is pushing consumers further down the pecking order to still less-desirable alternatives and further out of the mainstream financial system. It is difficult to see how this process of systematically restricting choices for those who already have limited choices is a strategy that is likely to benefit low-income consumers.

These detailed examples are only illustrative. The return of market-replacing regulation that mandates, prohibits, or limits certain substantive terms of consumer credit contracts is becoming more aggressive. For example, in 2015 alone the Bureau of Consumer Financial Protection (CFPB) announced a proposal that would impose new underwriting requirements on all short-term credit products (such as payday and auto title loans), a proposal that is predicted to reduce the revenues of payday lenders by 82 percent, driving most small lenders out of the market and thereby reducing competition and consumer choice.[28] The CFPB's Qualified Mortgage and Ability-to-Repay rules governing residential mortgages, which dictate the terms of purportedly safe mortgages, are driving many community banks out of the mortgage market, thereby reducing competition and consumer choice.[29] And finally, in October 2015 the CFPB announced a preliminary proposal that would prohibit enforcement of provisions in consumer credit contracts that require arbitration and limit consumer access to class actions.[30] In each situation, the CFPB has intervened to impose substantive limits on contract terms and products without any tangible showing of consumer harm or lack of capacity to understand the relevant terms.

TOWARD A MARKET-REINFORCING APPROACH TO CONSUMER CREDIT

Given the centuries of evidence that market-replacing regulation of consumer credit products does not work and actually tends to harm those it is supposedly intended to help, it is time for a new approach to the regulation of consumer credit. Such an approach can be referred to as a market-reinforcing approach to consumer credit regulation.

But it must be stressed that a true market-reinforcing approach to consumer credit regulation is not simply a return to disclosure-based regulation. The criticisms of disclosure-based regulation are well taken—in particular that disclosures are not well tailored to meet the particular needs of consumers. Instead, disclosure-based regulation inevitably tended toward the production of long, prolix, complicated disclosures written primarily to placate regulators and to avoid class-action litigation. Risk-averse regulators and financial institutions have felt it safer to “err on the side of disclosure,” disclosing all terms and conditions in excruciating detail, rather than risking a failure to disclose some term in sufficient detail that might later give rise to the claim by a class-action lawyer that a salient term was not disclosed properly or fully. Thus, while disclosure regulation was generally preferable to substantive regulation of terms and products, it was still not truly consumer- and competition-centered, as it failed to take into account how consumers actually make decisions and how markets actually work.

Disclosure regulation also suffers from a second problem. As with any other bureaucratic system, once particular disclosures are mandated by legislation or regulation they are frozen in place and are difficult to update or modify as market conditions change. Consider, for example, the so-called Schumer Box, which imposes a requirement that all credit card offers highlight certain terms and conditions that regulators considered (at the time) to be especially important for consumers to know. While some of the terms that must be prominently disclosed may (or may not) have been important at the time Schumer Box disclosures were mandated, many of them are largely irrelevant today or relevant only to very few consumers. For example, virtually every credit card charges a “minimum interest charge” of $0.50. In addition, only a small number of consumers take cash advances on their credit cards, yet the Schumer Box requires disclosure of the cash-advance fee at the time of applying for a card. By mandating disclosure of terms that are irrelevant for most consumers, mandated disclosure requirements tend to overload consumers and make it more difficult for them to actually find and focus on the terms that are most relevant and important to them.

The failure of disclosure regulation to accomplish its intended purposes has led some analysts to draw a different—and, in many cases, opposite—conclusion, but one that is equally flawed. Some scholars, mostly working under the flag of “behavioral law and economics,” have argued that certain financial products are excessively complicated for consumers to understand and that consumer financial products should be forcibly simplified so that their salient terms can be disclosed to consumers. For example, professors Michael Barr, Sendhil Mullainathan, and Eldar Shafir have argued for the primacy of "plain vanilla" consumer financial products, which financial institutions would be required to offer consumers and consumers would be required to affirmatively reject before those financial institutions would be permitted to offer alternative and more complicated products.[31] For example, before a lender could offer to a consumer an adjustable-rate mortgage, a lender would be required to offer consumers the option of a thirty-year fixed-rate mortgage and to explain to the borrower the advantages of the plain vanilla product, which the consumer would be required to affirmatively reject. Indeed, this novel idea proved so influential that it was included in the Obama administration's original legislative proposal that eventually became Dodd-Frank.[32]

But the flaws of the plain-vanilla approach to consumer financial protection are in many ways the opposite of the flaws in the disclosure regime. The criticism of a disclosure regime is that some products are so complicated that it is difficult to disclose all of the potentially relevant terms up-front without creating information overload problems for consumers. The criticism of a plain-vanilla regime, by contrast, is that the complexity of product offerings would be bounded by the limits of what a consumer can understand at the time of entering into a credit contract. Thus, the logic of a plain-vanilla regulatory regime is to work backward from what can be reasonably disclosed and understood by a consumer at the time of entering into a contract and then limit the number of terms in that fashion.

The flaws in such a regime, however, are obvious. While one can require the offer of plain-vanilla products, advocates of the plain-vanilla regulatory regime have yet to identify any plain-vanilla consumers for whom these one-size-fits-all products are appropriate. Consumer credit products are complicated because consumers are complicated and the products that they use are complicated. About half of consumers never or rarely revolve balances on their credit card—those consumers pay little attention to the annual percentage rate (APR) or related credit features of a credit card, but pay substantial attention to terms like the annual fee or rewards. Consumers also differ with respect to what kinds of rewards they value. Other consumers do revolve balances at different frequencies, or use their credit cards abroad, or use their personal credit cards for business purposes or even as a source of financing for a small business. It becomes apparent very quickly that in the face of consumer heterogeneity, a plain-vanilla regulatory strategy will soon turn one-size-fits-all into one-size-fits-none. Moreover, as exemplified by the CARD Act, when certain risk-based pricing terms are limited, such as over-the-limit fees or the ability to adjust interest rates in the face of changes in risk, it favors those advantaged consumers but does so at the expense of other consumers who have to pay higher interest rates and annual fees, or lose access to credit cards entirely.

A market-based approach to consumer financial protection, therefore, will be one that does not drown consumers in excessive disclosures of irrelevant terms but also does not force consumers and financial institutions into oversimplifying their product offerings just to shoehorn them into standardized formats. Instead, a true market-reinforcing consumer financial protection regime will start with a foundation that consumers are the best judge of the terms and products that are best for themselves and their families and that the purpose of regulation should be to help consumers to identify their preferred products most efficiently.

A market-based consumer financial protection regime would begin by specifying the market failure that purportedly is to be addressed by the regulation.[33] Thus, if the problem to be addressed is one of information (i.e., that consumer preferences are taken as given and it is a matter of enabling them to find their preferred products efficiently), then the remedy should be informational. But if the problem is substantive (i.e., that regulators do not want consumers to make certain choices), then one should not invoke informational remedies. Thus, for example, if politicians believe that consumers take on too much credit card debt and do not pay it off fast enough, trying to change consumer behavior through disclosure-based regulation (such as requiring conspicuous disclosure of how long it will take to pay off the balance if one makes only the minimum payment) will be an ineffective way to achieve that end.

Indeed, using disclosure to try to accomplish substantive goals of changing consumer behavior can actually be counterproductive. For example, evidence indicates that the new required disclosure on credit card statements actually may have caused the number of consumers who only made the minimum monthly payment to *increase*.[34] In a similar vein, when the Department of Housing and Urban Development proposed a rule that would have required separate disclosure of fees charged by mortgage brokers (which were irrelevant to the price of the loan to the consumer), a study by economists at the Federal Trade Commission found that the proposed disclosure actually *increased* consumer confusion and led them to make mistakes about the overall cost of the loan.[35] In both instances, the proposed disclosure remedy was not well tailored to the problem it was supposed to address.

But markets actually already offer a better way. Consider a website such as cardhub.com, which is operated by a former credit card industry executive.[36] The website reads through the dense pages of credit card terms and disclosures and interprets the card terms for consumers. Moreover, rather than throwing a bunch of generic disclosures at consumers—disclosures that are both overinclusive and underinclusive for virtually every consumer—cardhub.com enables consumers to search for cards with the specific attributes that particular consumers value, whether a low APR, zero foreign transaction fee, gasoline rewards, or frequent flyer miles. In effect, cardhub.com and other similar websites allow consumers to tailor disclosures to the terms that they consider most relevant at the time that they make their decision and then to find other terms as needed. In addition, terms that have become obsolete with respect to a consumer's decision (such as the minimum finance charge) can be ignored unless a consumer specifically wants to know that term. In contrast to the cumbersome one-size-fits-all strategy of government-mandated disclosure, cardhub.com provides a model that lets consumers wade through the inherently complex nature of modern credit cards without forcing financial institutions to artificially simplify their products to shoehorn them into a preexisting model of disclosure.

In this sense, shopping for a credit card has become no different from shopping for any other multifeature product, such as a car, refrigerator, or computer. In such markets consumers rely on their own experiences, information from advertising, and independent third-party rating institutions such as Consumer Reports, Angie's List, or Carfax. Credible third-party rating agencies can provide information to help consumer decision-making.

Moreover, simplicity itself is a product attribute consumers value in competitive markets. For example, the global popularity of Apple's iPhone is attributable in substantial part to its simplicity of use in comparison to Android-based phones, even though Androids are less expensive. There is good reason to believe that financial institutions will respond to consumer demand for simplicity as well. For example, consider general-purpose reloadable (GPR) prepaid cards, which serve as a payment alternative to debit and credit cards.[37] When GPR cards were first introduced and started to become mainstream, they were laden with multiple fees—activation fees, cash-withdrawal fees, transaction fees, and so on. As the GPR prepaid market has expanded and competition has grown, however, both the number and dollar amount of the fees charged on the cards have fallen dramatically. Today, cards issued by American Express (through Walmart), JPMorgan Chase, US Bank, and others, all offer high functionality with a very simplified fee structure. Indeed, by the time that financial regulators actually started considering regulating the number and size of fees on prepaid cards, market competition was already delivering to consumers quality cards with fewer and smaller fees. Indeed, today the largest obstacle to competition and consumer choice in the prepaid card market is the Durbin Amendment, which requires that to avoid its punitive price controls, large-bank issuers subject to its terms (over $10 billion in assets) must offer cards with reduced functionality that effectively cannot serve as a mobile banking substitute for a traditional bank account.

Finally, the Durbin Amendment itself is one of the more glaring examples of how not to create a market-reinforcing regulatory regime. The growth of free checking and improved quality of bank accounts during the 2000s, combined with the great popularity of debit cards as a payment instrument, is a remarkable story of pro-consumer competition and innovation. The growth of debit cards enabled banks to expand free checking to many groups that traditionally did not have access to bank accounts—for instance, low-income and young consumers. More important, the growth of debit cards and the interchange fees that they generated turned these low-income Americans into valued bank customers—banks had an incentive to open new branches, including branches in untraditional locations such as grocery stores, in order to attract a new class of customers. Banks had an incentive to expand their mobile banking platforms and online banking systems to attract tech-savvy younger consumers (many of whom had limited access to credit cards, in part because of regulations limiting access to credit cards by college students), among whom uptake of debit cards was especially popular. In short, the growth of debit card interchange fee revenues created a whole new class of consumers who were actually profitable and thus valued customers.

The Durbin Amendment, however, changed that calculus. Because the Durbin Amendment prohibits the recovery of the full cost of debit card issuance and servicing, it has effectively turned what had been a profit center into a loss. Banks now offer debit cards at a loss and must recoup their losses by selling other services to their customers or requiring larger minimum deposit balances to support their operation. Indeed, according to one report, as a result of the Durbin Amendment, JPMorgan Chase now estimates that approximately 70 percent of its customers with less than $100,000 in assets are unprofitable for the bank.[38]

The Durbin Amendment has effectively eliminated low-income and young consumers as profitable customers of the bank, and the consequences have been predictable—these consumers are exiting the banking system or never entering it. One fears that confronted with a growing class of unbanked consumers, regulators will essentially force banks to offer bank accounts at a loss to consumers.[39] Wouldn't it be better for all—and especially the consumers themselves—to provide economic incentives to treat low-income consumers as valued customers, rather than forcing them to serve those customers as a charity case?

A modern approach to consumer credit regulation should recognize and embrace the dynamic and innovative nature of consumer credit and payments. Mobile phone technology offers the potential to empower consumers to gain access to new information and make better decisions about the products that they choose. The reimposition of old-style command-and-control regulation, by contrast, threatens to stifle this innovation, competition, and flexibility.

NOTES

1. These conceptual categories are not intended to provide a taxonomic categorization of all regulations but to illustrate different approaches to regulation.
2. Durkin et al., *Consumer Credit and the American Economy*, 483.
3. These arguments are reviewed in ibid., chap. 11.
4. See ibid.
5. See ibid., 504; see also Zywicki, "Economics of Credit Cards" (credit cards), and "Case against New Restrictions."
6. See Durkin et al., *Consumer Credit and the American Economy*, chap. 5.
7. Regulation can dampen competition among providers, such as by imposing different usury ceilings for different products or providers or by erecting regulatory barriers to entry such as licensing of entrants. In such situations it is more plausible that certain firms could have monopoly power. See ibid., 506–9.
8. Marquette National Bank v. First of Omaha Service Corporation, 439 U.S. 299 (1978).

9. Today, most cards that carry annual fees also provide some sort of reward program (such as frequent flyer miles) for which the annual fee is used to defray some of the costs of the program operation. The frequency and size of annual fees has risen since the enactment of the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009, especially for higher-risk borrowers. See Durkin, Elliehausen, and Zywicki, "Assessment of Behavioral Law."
10. See Zywicki, "Case against New Restrictions."
11. Dunkelberg and De Magistris, "Measuring the Impact of Credit Regulation."
12. See Zywicki, "Consumer Financial Protection Bureau," 856.
13. Some smaller retailers outsourced their credit operations to consumer finance companies to try to keep costs down.
14. See Boyes, "In Defense of the Downtrodden."
15. See, for example, Samuelson, "Statement before the Committee of the Judiciary"; see also Friedman, "Defense of Usury," which says, "I know of no economist of any standing from [Bentham's] time to this who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive—though there must have been some."
16. See Durkin and Elliehausen, *Truth in Lending*.
17. See Durkin et al., *Consumer Credit and the American Economy*; see also Ben-Shahar and Schneider, *More than You Wanted to Know*.
18. See Zywicki, "Market for Information," 13.
19. Durkin, "Requirements and Prospects," 26.
20. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111–24, 123 Stat 1734 (2009) codified at 15 U.S.C. § 1601.
21. For a summary of the evidence on the effects of the CARD Act, see Durkin et al., "Assessment of Behavioral Law," which this discussion summarizes.
22. 15 U.S.C. §16930-2(a)(2).
23. Zywicki, Manne, and Morris, "Price Controls on Payment Card Interchange Fees."
24. See Wang, "Debit Card Interchange Fee Regulation."
25. Zywicki, Manne, and Morris, "Price Controls on Payment Card Interchange Fees."
26. FDIC, "2011 FDIC National Survey," 10.
27. In the period immediately following the enactment of the Durbin Amendment, usage of debit cards flatlined while usage of credit cards increased substantially, which reversed a multiyear trend of declining credit card purchase volume. Moreover, virtually all of the growth in credit card usage was for transactional users who pay their debts in full at the end of each month, suggesting that the increase in credit cards was for transactions for which debit cards otherwise would have been used.
28. See Baines, Courchane, and Stoianovici, "Economic Impact on Small Lenders."
29. See Zywicki "Dodd-Frank Act Five Years Later."
30. CFPB, "Small Business Advisory Review Panel." For a criticism of the study on which the proposal is based, see Johnston and Zywicki, "Consumer Financial Protection Bureau's Arbitration Study."
31. Barr, Mullainathan, and Shafir, "Behaviorally Informed Financial Services Regulation."
32. Department of the Treasury, "Financial Regulatory Reform."

33. See Zywicki, “Market for Information,” 13.
34. Navarro-Martinez et al., “Minimum Required Payment.”
35. Lacko and Pappalardo, “Improving Consumer Mortgage Disclosures.”
36. This observation is not intended to endorse this particular website over myriad similar competitors; it is provided for illustrative purposes.
37. See Zywicki, “Economics and Regulation.”
38. Marcinek, “JP Morgan Sees Clients.”
39. See Cordray, Letter to CEO of Unnamed Financial Institution.

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