THREE PROBLEMATIC TRUTHS ABOUT THE CONSUMER FINANCIAL PROTECTION AGENCY ACT OF 2009

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Three Problematic Truths About the

Consumer Financial Protection Agency Act of 2009

Joshua D. Wright & Todd J. Zywicki[♦]

Abstract

The creation of a new Consumer Financial Protection Agency ("CFPA") is a very bad idea and should be rejected. The proposal is not salvageable and cannot be improved in substance or in form. The foundational premise of the CFPA is that a failure of consumer protection, and specifically irrational consumer behavior in lending markets, was a meaningful cause of the financial crisis and that the CFPA would have or could have averted the crisis or lessened its effects. To the contrary, there is *no* evidence that consumer ignorance or irrationality was a substantial cause of the crisis or that the existence of a CFPA could have prevented the problems that occurred. The CFPA is likely to do more harm than good for consumers. In this article, we highlight three fundamentally problematic truths about the CFPA: (1) The CFPA is premised on a flawed understanding of the financial crisis, (2) the CFPA will have significant unintended consequences, including but not limited to reducing competition, consumer choice, and availability of credit to consumers for productive uses; and (3) the CFPA creates a powerful bureaucracy with undefined scope, risking expensive and wasteful regulatory overlap at both the federal and state levels without any evidence of its own expertise in the core areas it is designed to regulate.

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The creation of a new Consumer Financial Protection Agency ("CFPA") is a very bad idea and should be rejected. The proposal is not salvageable and cannot be improved in substance or in form. The proposal is premised on a fundamental misunderstanding of the causes of the financial crisis. The Obama Administration's *Financial Regulatory Reform* White Paper, and the intellectual underpinnings of the new CFPA as articulated by law professors Elizabeth Warren of Harvard and Oren Bar-Gill of New York University, set forth the blueprints for a powerful regulatory agency designed to react to a perceived failure of consumers to understand innovative financial products. The foundational premise of the CFPA is that a failure of consumer protection, and specifically irrational consumer behavior in lending markets, was a meaningful cause of the financial crisis and that the CFPA would have or could have averted the crisis or lessened its effects.

Neither the White Paper nor Bar-Gill and Warren offer a scintilla of evidence to support these claims. Let us repeat that to make it clear—there is *no* evidence that consumer ignorance or irrationality was a substantial cause of the crisis or that the existence of a CFPA could have prevented the problems that occurred. In this article, we highlight three fundamentally problematic truths about the CFPA:

(1) The CFPA is premised on a flawed understanding of the financial crisis.

(2) The CFPA will have significant unintended consequences, including but not limited to reducing competition, consumer choice, and availability of credit to consumers for productive uses;

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(3) The CFPA creates a powerful bureaucracy with undefined scope, risking expensive and wasteful regulatory overlap at both the federal and state levels without any evidence of its own expertise in the core areas it is designed to regulate.

I. The CFPA Is Premised on a Flawed Understanding of the Causes of the Financial Crisis

The U.S. Department of the Treasury proposed the creation of a new agency for protecting consumers of financial products on June 17, 2009.[1] About a month later it submitted draft legislation to Congress for the Consumer Financial Protection Agency Act of 2009.[2] The CFPA would "promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services"[3] and take over the consumer protection functions of all other federal regulatory agencies.[4] The CFPA will impose more stringent disclosure requirements on lenders and other qualifying institutions,[5] require that lenders offer "plain vanilla" products designed and approved by the agency,[6] and prohibit products and contract terms that it determines are problematic for consumers according to an unspecified form of cost-benefit analysis.[7]

[1] UNITED STATES DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 55-75 (2009) [hereinafter New Foundation], available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (outlining proposals for various governmental regulations of financial services and credit products).

[2] UNITED STATES DEPARTMENT OF THE TREASURY, CONSUMER FINANCIAL PROTECTION AGENCY ACT OF 2009 (2009), *available at* http://www.financialstability.gov/docs/CFPA-Act.pdf [hereinafter CFPA Act] (proposing 2009 Consumer Financial Protection Agency legislation for passage by Congress).

[3] *Id*. at § 1021(a).

[4] These include the Federal Reserve Board of Governors, Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, National Credit Union Administration, and the Federal Trade Commission. *See id*. at § 1061(a). The CFPA would regulate all consumer financial products and services with two principle exceptions: (1) insurance would be excluded except for credit insurance, mortgage insurance, and title insurance; (2) investment products that are already regulated by the SEC or CFTC would be excluded. *Id*. at § 1082(d).

[5] CFPA Act, *supra* note 2, at § 1032.

[6] *Id*. at § 1036(b).

[7] *Id*. at § 1031(c).

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Importantly, the CFPA will also permit and encourage states to impose even stricter regulations on financial products and services than those adopted by the CFPA.[8]

The U.S. Department of the Treasury claims that the failure of consumer protection helped caused the financial crisis and that a new federal agency with enhanced powers is therefore needed.[9] The White Paper argues that this situation resulted because of inadequate consumer protection regulation:

> The spread of unsustainable subprime mortgages and abusive credit card contracts highlighted a serious shortcoming of our present regulatory infrastructure. It too easily allows consumer protection values to be overwhelmed by other imperatives – whether short-term gain, innovation for its own sake, or keeping up with the competition. To instill a genuine culture of consumer protection and not merely of legal compliance in our financial institutions, we need first to instill that culture in the federal regulatory structure. For the public to have confidence that consumer protection is important to regulators, there must be clear accountability in government for this task.[10]

President Obama also suggested that the new consumer protection agency was needed in part because consumers had chosen to take out too much credit: "And this is essential, for this crisis was not just the result of decisions made by the mightiest of financial firms; it

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[8] *Id*. at § 1035(a). Currently, OCC rules preempt states from supervising, examining and regulating the business activities of national banks and their operating subsidiaries. 12 C.F.R. pt. 7, 34; UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS (2006), *available at* http://www.gao.gov/new.items/d06387.pdf.
[9] New Foundation, *supra* note 1, at 55.
[10] *Id*. at 56.

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was also the result of decisions made by ordinary Americans to open credit cards and take out home loans and take on other financial obligations."[11]

Professors Bar-Gill and Warren, prominent legal academics who have provided the original intellectual foundation for the CFPA,[12] have argued that a new and powerful agency is required to deal with "dangerous" financial products and services that can "as evidenced by the recent subprime crisis . . . have devastating effects on communities and the economy."[13] Along similar lines, Professor Michael Barr, a University of Michigan Law School professor who is now the Assistant Secretary of the Treasury responsible for the draft legislation, and several co-authors, have expanded upon the proposed Bar-Gill/Warren agency by detailing key aspects of its regulatory approach in an October 2008 paper.[14] These intellectual architects of the CFPA assert that irrational consumer behavior is at the heart of the financial crisis, and that the CFPA is needed to "nudge" consumers toward better decision making in lending markets.

The creators and the defenders of the CFPA are wrong on both counts. They misunderstand actual causes of the financial crisis. They also erroneously assume that the behavioral law and economics literature, which consists of a number of studies in economics and psychology that find that consumers appear to make various systematic mistakes evaluating probabilities and discounting future values, and, further, that consumers make various choices that appear inconsistent with each other, provides an

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

[12] Professor Warren is currently is currently the head of the Congressional Oversight Panel on TARP funding.

[13] Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 101, 101 (2008).

[14] Michael S. Barr, Sendhil Mullainathan & Eldar Shafir, *Behaviorally Informed Financial Services Regulation* (New American Foundation, Working Paper, October 2008).

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adequate intellectual and evidentiary basis for the creation of the CFPA and its proposed regulations. We discuss each in turn.

A. The Causes of the Financial Crisis

It is true that lenders made a huge number of loans that were foolish in retrospect and perhaps should have been recognized as foolish at the time. And these unwise loans presented, and continue to present, major problems for the safety and soundness of the American banking sector. But it is critical to understand that these loans were foolish *not* because consumers did not understand them but because lenders failed to appreciate the incentives for rational, fully-informed consumers to default on these loans if circumstances changed.

Consider an extreme, but not unrealistic scenario: A California borrower took a nothing-down, interest-only, adjustable-rate mortgage to buy a new home in the far-flung exurbs of Northern California, planning to live in the house for a few years and then resell it for a profit. Assume further that the borrower could continue to make his mortgage payment if he chose to do so. Instead, the house plunged in value so that it is worth much less than the outstanding mortgage and with widespread oversupply of housing there is no reasonable likelihood that it will come back above water in the near future. Under California's defaulter-friendly, antideficiency laws, the lender is limited to foreclosing on the house and cannot sue the borrower for the difference between the value of the house and the amount owed on the mortgage. As a result of all of this, the homeowner crunches the number, consults his lawyer, and decides to walk away from the house and allow foreclosure.

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This scenario raises substantial concerns about the safety and soundness of such loans. One can ask whether banks should be permitted to make loans that provide such strong incentives for a borrower to default when the loan falls in value. In fact, empirical evidence suggests that many of the terms that have drawn much criticism (such as low-documentation loans) proved to be problematic only when combined with other provisions that reduced borrower equity, such as nothing-down.[15] But while this scenario presents major concerns about the safety and soundness of such a loan, it does *not* present a consumer protection issue. The end result of foreclosure results from the set of incentives confronting the borrower and the borrower's rational response to them—empirical research indicates that loans with no down payment or which otherwise cause borrowers to have low or no equity in their homes (including interest-only, home equity loans, and cash-out refinances) have proven to be especially prone to foreclosure in the recent crisis as stripping equity out of ones' house makes it more likely that a price drop will push the house into negative equity territory thereby providing incentives to default on the loan.

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[15] KRISTOPHER GERARDI ET AL., MAKING SENSE OF THE SUBPRIME CRISIS, BROOKINGS PAPERS ON ECONOMIC ACTIVITY (Douglas W. Elmendorf, N. Gregory Mankiw, and Lawrence Summers eds., Fall 2008).
[16] *Id*.

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not present a consumer protection issue. Foreclosure is the end result culminating from a set of incentives confronting the borrower and the borrower's rational response to them.

Rather than recognizing the financial crisis as the product of misaligned incentives that has created major safety and soundness issues, the Obama Administration's proposal for a CFPA rests on the assumption that the financial crisis was produced by hapless consumer victims being exploited and defrauded by unscrupulous lenders and turns to policies informed by behavioral economics to "nudge" consumers into "more rational" decisions.

B. New Paternalism of Behavioral Economics Does Not Provide an Adequate Justification for the CFPA and Its Proposed Regulations

The CFPA is predicated on the fundamentally mistaken assumption that consumer irrationality led to the financial crisis. The CFPA, led by the work of Bar-Gill and Warren and others, rely on the "behavioral law and economics" literature[17] to lay the intellectual foundation for the CFPA and its proposed regulations that would, in theory, "nudge" consumers towards correcting these mistakes. The proponents argue that "[m]any consumers are uninformed and irrational,"[18] that consumers make "systematic mistakes in their choice of credit products and in the use of these products,"[19] and that regulators should adopt a number of "behaviorally informed" policies designed to address the consequences of consumer ignorance and irrationality.[20] There are a number of problems

[17] This literature consists of a number of studies in economics and psychology that find that consumers appear to make various systematic mistakes evaluating probabilities and discounting future values, and, further, that consumers make various choices that appear inconsistent with each other. For a summary of this literature, *see* Christine Jolls, *Behavioral Law and Economics*, *in* ECONOMIC INSTITUTIONS AND BEHAVIORAL ECONOMICS (Peter Diamond ed., Princeton University Press 2006); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).
[18] *See* Bar-Gill & Warren, *supra* note 13, at 21; Barr et al., *supra* note 14, at 1.
[19] Bar-Gill & Warren, *supra* note 13, at 26.
[20] *See generally* Barr et al., *supra* note 14, at 1.

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with this set of assumptions. For example, as we will discuss below, how will regulators insulated from the pressures of competitive markets, who are presumably also afflicted with the same cognitive biases and prone to the same sorts of mistakes, objectively identify and distinguish harmful from beneficial lending products?

But even holding aside these unanswered questions, the very core assumptions that consumer irrationality has been adequately linked to the financial crisis is misplaced. As noted above, while there was undoubtedly fraud during the housing boom (both by borrowers and lenders) the problems that have been seen in the mortgage market are the result of rational consumer responses to incentives, not a problem of fraud, consumer confusion, or systematic irrationality. The housing crisis—referring specifically to the problem of foreclosures—has little to do with the issues identified by the White Paper and thus an entity such as the CFPA would make little difference in averting a similar problem in the future.

At its core, the CFPA mission embraces the view that consumer finance regulation should be based on the notion that consumers don't make rational decisions because they don't understand financial products. At least one appropriate regulatory response, it is assumed, is to design "plain vanilla" products that must be offered to borrowers while consumers are "nudged" toward the selection of those products rather than more exotic non-vanilla variants. Unfortunately, at this point there is simply no evidence that consumer irrationality contributed to the financial crisis. Consider the substantial empirical evidence, for example, that buyers in consumer markets such as

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credit cards and supermarkets act quite rationally most of the time and frequently learn from mistakes when the costs of doing so are low.[21]

Even if one assumed without evidence that consumer irrationality was a substantial contributor to the financial crisis warranting additional regulation, regulations pushing consumers toward "plain vanilla" lending products is problematic from an economic perspective for several reasons.

First, while non-vanilla products might not be best for everyone, raising the costs to consumers for whom those products make economic sense will lower welfare. Consumers have a heterogeneous preferences and it does not generally make economic sense to impose regulatory hurdles limiting consumers' ability to satisfy those preferences.

Second, it is no defense to argue that the CFPA will allow lenders to include non-standard products, maintaining consumer choice, so long as they also include the CFPA-approved product design. There are a variety of "nudge" style requirements that might be imposed on consumers who rationally would prefer to adopt the disfavored mortgage products, including the power to prohibit disfavored products entirely.[22] Further, it would seem doubtful that the CFPA would have the ability and knowledge to determine that a "plain vanilla" product is better for a consumer, who knows their own preferences and circumstances, than the other products being provided by the lender

Third, to the extent that consumer irrationality is a problem, this paternalistic approach reduces the incentives for consumers to improve decision making over time by

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[21] *See* Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective*, 2 NYU J. L. & LIBERTY 470 (2007) (surveying empirical evidence of consumer behavior in consumer credit and other contexts).
[22] CFPA Act, *supra* note 2, at §§ 1041(a)(1)-(a)(2).

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learning. The practical and economic significance of these effects are important factors that should have been considered and weighed against the merits of the current proposal. All of these are potentially significant costs of the new regulatory approach to financial products for consumers. However, consumer irrationality has not been demonstrated to be an important causal factor in the financial crisis. Rather, proponents of the CFPA have assumed irrationality to have a significant causal role without empirical evidence and proposed solutions that are more likely to harm than help most consumers.

As mentioned, it is also problematic that the so-called behavioral economic approach to regulating consumer products shifts decision making from consumers to regulators who are presumably afflicted with the same cognitive biases and irrationalities as everyone else. Defenders of the proposal, such as Richard Thaler, have minimized this concern by arguing that consumers rely on experts frequently and even if our regulators are imperfect, they certainly can improve matters because of their superior expertise relative to the average consumer.[23] For instance, consumers trust trained but imperfect mechanics because it beats fixing the car ourselves. The critical distinction here, of course, is that we trust mechanics because they are specialists who operate under the pressure of competitive forces and reputation and have incentives to perform well that differ greatly from those of government agents who are relatively immune from those forces.

It bears repeating that there is simply no empirical evidence demonstrating that consumer irrationality was a significant cause of the financial crisis, much less that the proposed regulations envisioned by the CFPA would have solved any existing problems.

[23] *See* Paul Solman, Thaler Responds to Posner on Consumer Protection (last visited Sep. 8, 2009), http://www.pbs.org/newshour/businessdesk/2009/07/thaler-responds-to-posner-on-c.html.

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Consider, for example, that despite assertions by proponents of the CFPA to the contrary about the economic consequences of non-standard mortgage products, economic research has overwhelmingly concluded that one factor that was *not* important were so-called "teaser rates" on subprime mortgages. Critics have claimed that these hybrid mortgages were "exploding" mortgages in that the initial teaser rate was set excessively low and that there would be a dramatic upward shot in interest rates after the interest rate reset that would surprise borrowers with high interest rates, and that this has helped to generate rising foreclosure rates. Although often cited, this theory appears to lack any empirical foundation.

One estimate of subprime loans facing foreclosure in the early wave of foreclosures found that 36% were for hybrid loans, fixed-rate loans accounted for 31%, and adjustable-rate loans for 26%.[24] Of hybrid loans in foreclosure, the overwhelming majority entered foreclosure *before* there was an upward reset of the interest rate.[25] Most defaults on subprime hybrid loans occurred within the first 12 months of the loan, well before any interest adjustment.[26] For those borrowers who actually underwent an interest-rate reset, the new rate was higher, but not dramatically so when compared to the original rate.[27] On average, the rate for subprime borrowers from the period 2003-2007 adjusted from an initial rate of about 8% to about 11%—a substantial adjustment, but not

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[24] James R. Barth et al., *Mortgage Market Turmoil: The Role of Interest-Rate Resets*, *in* SUBPRIME MORTGAGE DATA SERIES (Milken Inst. 2007); C.L. Foote, K. Gerardi, L. Goette & P.S. Willen, *Subprime Facts: What (We Think) We Know about the Subprime Crisis and What we Don't*, FED. RES. BANK BOSTON PUBLICLY POLICY DISCUSSION PAPER 08-02 (2007); C. Mayer, K. Pence, & S.M. Sherlund, *The Rise in Mortgage Defaults: Facts and Myths*, 23 J. ECON. PERSPECTIVES 27 (2009).

[25] Barth et al., *supra* note 24, at 2. Of those subprime loans in foreclosure at the time of his study, 57% of 2/28 hybrids and 83% of 3/27 hybrids "had not yet undergone any upward reset of the interest rate."

[26] Mayer, Pence & Sherlund, *supra* note 24, at 11 (Mayer, Pence, and Sherlund find a dramatic rise in "early payment defaults" well before any interest rate adjustment takes place.); Shane Sherlund, *The Past, Present, and Future of Subprime Mortgages*, Federal Reserve Board (Sept. 2008); Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures* (Federal Reserve Bank of Boston, Working Paper no. 07-15, 2008).

[27] *See* Foote et al., *supra* note 24, at 16.

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one that can fairly be characterized as "exploding." Moreover, mortgage interest rates generally were increasing during this period (the spread between the initial and reset rates generally narrowed during this period), so the higher rate on reset also might have reflected a general rise in ARM interest rates, not the hybrid nature of the loan. Economists Anthony Pennington-Cross and Giang Ho find that the transition in a hybrid loan from an initial fixed period to the adjustable rate period results in heightened rates of prepayment but *not* default.[28] They also find that the termination rate for subprime hybrid loans (whether by prepayment or default) was comparable to that for prime hybrid loans. In light of these facts, economists have almost universally concluded that hybrid mortgages (at least alone) cannot explain the rise in foreclosures. After examining the evidence, several economists from the Boston Federal Reserve flatly stated last year, "Interest-rate resets are not the main problem in the subprime market."[29] We are aware of no evidence that contradicts that conclusion.

C. The CFPA and Credit Cards

Credit cards are singled out for special criticism in the Obama Administration's White Paper, as well as Bar-Gill and Warren's article, despite the fact there is scant evidence that borrowers are unable to meaningfully understand their credit cards or shop effectively for credit cards. According to a survey by former Federal Reserve economist Thomas Durkin, 90% of consumers report that they are "Very" or "Somewhat Satisfied" with their credit cards.[30] Durkin also found that two-thirds of credit card owners find it "very easy" or "somewhat easy" to find out information about their credit card terms, and

[28] *See* Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages* 18 (Fed. Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006).
[29] *See* Foote et al., *supra* note 24, at 48.
[30] Thomas Durkin, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, FEDERAL RESERVE BULLETIN (April 2002).

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only six percent believed that obtaining this information was "very difficult." Two-thirds of respondents also reported that credit card companies usually provide enough information to enable them to use credit cards wisely. In an ideal world, these figures might be even higher, but the White Paper does a great disservice to American consumers when it implies that consumers are unable comprehend their credit cards or to acquire the information that they need to make reasonable choices.

More importantly, consumers pay attention to and understand the credit card terms that matter most *to them* personally. Consumers who revolve credit card balances are extremely likely to be aware of the interest rate on their credit cards and to comparison shop among cards on that basis, and those who carry larger balances are even more likely to be aware of and comparison shop on this term than those who revolve smaller balances.[31] By contrast, those who do not revolve balances tend to focus on other aspects of credit card contracts, such as whether there is an annual fee, the grace period for payment, or benefits such as frequent flier miles. In fact, consistent with the observation of more aggressive interest rate shopping by revolvers, those who revolve balances are charged *lower* interest rates on average than those who do not.[32] American consumers are not passive sheep timidly waiting to be shorn, as implied by the White Paper.

Elevating certain "plain vanilla" loans for exalted status also poses a risk of chilling vigorous competition and innovation in lending products. Consider the dramatic

[31] *See* Thomas A. Durkin, *Credit Card Disclosures, Solicitations, and Privacy Notices: Survey Results of Consumer Knowledge and Behavior*, FEDERAL RESERVE BULLETIN, 2006, at A 109.
[32] Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHICAGO L. REV. 63 (2006).

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innovations and improvements in credit cards over the past several decades.[33] Thirty years ago credit cards were an immensely simple product—a high annual fee, a high fixed interest-rate, and no benefits such as cash-back, frequent-flyer miles, purchase-price protection, etc. Bank cards were available only to a lucky few. The remainder of middle-class consumers who needed credit were forced to rely on credit from local department stores or appliance stores, thereby obliging them to shop at those stores. These cards were simple—but lousy. The simplicity and uniformity of pricing stifled innovation and, some have alleged, made it easier for credit card issuers to collude to fix prices and stifle competition.

The effective deregulation of the credit card market by the Supreme Court's decision in *Marquette National Bank* set off a process of competition and innovation that continues to this day.[34] Annual fees have disappeared on all "plain vanilla" credit cards, remaining only for those cards that provide frequent flyer miles and the like. Virtually all credit cards have variable interest rates. And there is a much greater reliance on behavior-based fees, such as over-the-limit fees, late fees, and the like. The combination of these innovations has resulted in more accurate risk-based pricing for cards and less cross-subsidization by low-risk users of higher-risk users of credit cards. True, credit card pricing has become more complicated—but that is largely because consumer use of credit cards is so much more complicated and varied than in the past. It would be extremely unwise for a hypothetical CFPA to try elevate simplicity above all else without considering the impact of its actions on competition, innovation, and consumer choice.

[33] For a discussion of this history, *see generally* Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).
[34] Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299, 318 (1978).

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The parable of credit card innovation provides a warning lesson about a narrow fixation on simplicity.

II. The CFPA Will Have Unintended Consequences

A second major problem with the concept of the CFPA is the high likelihood of unintended consequences that will result from its actions, including reducing competition and valuable consumer choice. Consider, for example, the proposal to ban (or strongly discourage) prepayment penalties in mortgage products. This would likely prove counterproductive and harmful to consumers.

Prepayment penalties are a common term in many subprime mortgages, although they remain uncommon in most prime mortgages in the United States. Prepayment penalties are also included in most commercial loans and are present in virtually all European mortgages. Yet the White Paper contemplates banning prepayment penalties in mortgages. This reasoning is based on faulty economic logic and fails to recognize the overwhelming economic evidence supporting the efficiency of prepayment penalties.

The traditional American right to prepay and refinance a mortgage is relatively unique in the world. Available empirical evidence indicates that American consumers pay a substantial premium for this unlimited prepayment right. Borrowers pay a premium for the unlimited right to prepay of approximately 20 to 50 basis points (.2 to .5 percentage points) with subprime borrowers generally paying a higher premium for the right to prepay than prime borrowers because of the increased risk of subprime borrower prepayment.[35] Borrowers pay this premium to compensate lenders for the risk of having

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[35] *See* Todd J. Zywicki & Joseph Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 18-20 (2009) (summarizing studies); Gregory Elliehausen, Michael E. Staten & Jevgenijs

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to reinvest funds at lower market interest rates when interest rates fall. Where prepayment penalties are banned lenders also take other precautions to guard against the risk of prepayment, such as charging increased points or upfront fees at the time of the loan, which raise the initial cost of the loan.

Nor is there any evidence that prepayment penalties are excessively risky for consumers. Empirical evidence indicates that prepayment penalties do not increase the risk of borrower default. In fact, subprime loans that contain prepayment penalty clauses are less likely to default than those without such clauses, perhaps because of the lower interest rate on loans with prepayment penalties or perhaps because the acceptance of a prepayment penalty provides a valuable and accurate signal of the borrower's intentions.[36] Acceptance by a borrower of a prepayment penalty may also provide a credible signal by the borrower of his intent not to prepay the loan, thus overcoming an adverse selection in the marketplace and permitting a reduction in interest rates. Borrowers obviously have greater knowledge than lenders about the relative likelihood that the borrower will prepay the mortgage, especially in the subprime market where prepayment tends to be highly idiosyncratic and borrower-specific.[37]

The White Paper's approach to prepayment penalties is also internally illogical, stating that prepayment penalties "should be banned for certain types of products, such as subprime or nontraditional mortgages, or for all products, because the penalties make

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Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages*, 60 J. ECON. & BUS. 33, 34 (2008) (reviewing studies); Chris Mayer, Tomasz Piskorski & Alexei Tchistyi, *The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers* (Columbia Business School, Working Paper, 2008). Term sheets offered to mortgage brokers similarly quoted interest-rate increases of approximately 50 basis points in those states that prohibited prepayment penalties.

[36] Mayer et al., *supra* note 34, at 3; Sherlund also finds that the presence of prepayment penalties does not raise the propensity for default. Sherlund, *supra* note 26, at 11.

[37] *See* Zywicki & Adamson, *supra* note 35, at 16.

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loans too complex for the least sophisticated consumers to shop effectively."[38] This statement is confused in two respects. First, it conflates two different concepts—the complexity of prepayment terms on one hand and the ability of consumers to shop effectively on the other. If the concern is the ability to shop effectively, such as being able to compare competing offers, then the White Paper's concern could be met equally well by *mandating* prepayment penalties in every mortgage, thereby standardizing this term. In which case, it would no longer be a term on which consumers would need to compare across mortgages thereby rendering moot the question of the complexity of the term. Second, the statement refers to the inability of the "least sophisticated consumers" to be able to shop effectively. According to research by the Federal Trade Commission, however, those who have subprime mortgages are just as capable of understanding their mortgage terms as prime borrowers (or more accurately, neither group understands their loan terms very well).[39]

In still other cases the White Paper fails to consider the sophistication of the covered group at all. For instance, it identifies negative amortization loans as being especially complex and subject to particular scrutiny.[40] Mayer et al. find that negative amortization and interest-only loans were present in a significant minority of alt-A mortgages, but virtually nonexistent in subprime mortgages.[41] Yet although alt-A and subprime loans are often lumped together, there is reason to believe that many alt-A borrowers were highly-sophisticated borrowers who fully understood the risks of those

[38] New Foundation, *supra* note 1, at 68.
[39] JAMES M. LACKO AND JANIS K. PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007) *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf.
[40] New Foundation, *supra* note 1, at 66.
[41] Mayer, Pence & Sherlund, *supra* note 24, at 32-33. Mayer et al. find that 40% of alt-A mortgages had interest-only features, compared to 10% of subprime; 30% of alt-A mortgages permitted negative amortization, while subprime loans did not have these features. *Id*.

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products and alt-A mortgages were often used precisely to purchase larger and more expensive houses. More generally, negative amortization features do not appear to have been common in loans to ordinary borrowers or to subprime borrowers, but were limited to a particular subset of borrowers who often were highly-sophisticated and fully understood the risk of the loan and consciously chose to speculate that the home price would increase. We are aware of no evidence that those who held negative amortization loans failed to recognize or understand this term or the risks it entailed. Nor does the White Paper present any such evidence.

Finally, the ability of American consumers to freely prepay and refinance their mortgages may have exacerbated the current mortgage crisis—and banning prepayment penalties might thus exacerbate a similar situation in the future. When home prices were rising, many consumers refinanced their mortgages to withdraw equity from their homes. These "cash-out" refinancings became increasingly common during the duration of the housing boom: from 2003 to 2006, the percentage of refinances that involved cash-out rose doubled from under 40% to over 80%[42] and among subprime refinanced loans in the 2006-2007 period around 90% involved some cash-out.[43] In fact, even though there was a documented rise in LTV ratios between 2003-2007, even that may underestimate the true increase in the LTV ratio if appraisals for refinance purposes were inflated (either intentionally or unintentionally), as appraisals are a less-accurate measure of value than actual sales.[44] The ability to freely prepay and refinance one's mortgage may help to explain the higher propensity for American consumers to default than in comparably-

[42] Luci Ellis, *The Housing Meltdown: Why Did it Happen in the United States* 22 (Bank For International Settlements, BIS Working Paper 259, Sep. 2008), *available at* http://www.bis.org/publ/work259.pdf.
[43] C J Mayer & Karen Pence, *Subprime Mortgages: What, Where, and To Whom* (NBER, Working Paper no. 14083, 2008).
[44] Ellis, *supra* note 42, at 22; Mayer et al., *supra* note 24, at 6.

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situated countries where prepayment is more difficult and thus cash-out refinancings are not as common.

This suggests that a ban or limitation on contractual agreements for prepayment penalties would encourage even more refinancing activity and further equity depletion than would otherwise be the case—thereby having the unintended consequence of *increasing* the number of foreclosures.

More generally, the CFPA implicitly rests on the assumption that consumer credit is a commodity, and that product differentiation among consumer credit products is purely artificial, not a reflection of differences among credit users. Georgetown Law Professor Adam Levitin, a leading proponent of the establishment of the CFPA has summarized the argument succinctly (citing to a Credit Slips post of his):

> Credit is at core a commodity. A dollar from Chase is no different than a dollar from Bank of America. The only way high-cost products that skim consumer surplus are able to compete in the credit market is through price obfuscation. Some of this obfuscation is through fine-print. Some is through product design, as complexity and exploitation of consumers' cognitive biases can mask pricing. Credit cards have led the way with price obfuscation, but mortgages made up the gap, and other products are not far behind. Basically, the consumer credit market is a market in which competition often encourages bad products, and this calls for regulatory

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intervention.[45]

As Professor Levitin suggests, this proposition that consumer credit at root is a commodity is a fundamental intellectual linchpin of the case for a consumer financial protection agency: that product differentiation and product heterogeneity is artificial and fundamentally misleading and that government can identify and standardize the "proper" terms on which lenders should be permitted to compete. This view that product differentiation, satisfaction of heterogeneous consumer preferences, and competition on margins that are not pre-approved by regulators and scholars are somehow "artificial" is one that highlights the risks of unintended consequences for the CFPA. If this fundamental assumption is inaccurate—as it almost certainly is for at least small business users of credit and most individual users as well—then the intellectual justification for the coerced standardization promoted by the CFPA collapses.

III. The CFPA Will Be a Bureaucratic Nightmare

A final problem with the CFPA is that it creates a new bureaucracy with a defined scope, expertise, and mission, separate from other consumer protection agencies and safety and soundness regulators. In so doing, it will promote the very bureaucratic balkanization and inconsistency that it aspires to address.

A. Problems of Vagueness

The standard that the CFPA seeks to achieve is also unrealistic and suggests a virtually unlimited scope of authority for its action. The White Paper proposes that CFPA "should be authorized to use a variety of measures to help ensure alternative mortgages

[45] Adam Levitin, The Case for a Consumer Financial Protection Agency, Credit Slips, http://www.creditslips.org/creditslips/2009/07/the-case-for-a-consumer-financial-protection-agency.html (last visited Sep. 9, 2009).

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were obtained only by consumers who understood the risks and could manage them."[46] This statement fails to recognize, however, that very few homeowners understand all of the risks associated with their mortgages—whether traditional or alternative.[47] To establish such an unrealistic and implausible standard is to open up a capaciousness of regulatory discretion and authority that is simply stunning. This standard of perfect understanding has probably never been met in practice, even for the most simple mortgage and most sophisticated borrower. Yet most mortgages work well for most borrowers without mishap.

The CFPA Act adopts similarly vague standards that empower the new agency to regulate lenders, prohibit financial products and services, create exemptions, and design products unconstrained by any rigorous cost-benefit analysis or understanding of the likely impact of the regulation on competition, innovation or consumer choice. The CFPA grants incredibly broad statutory authority by design. Authority to determine what is a "standard financial product or service" subject to regulation by the CFPA "means a consumer financial product or service containing terms, conditions, and features defined by the Agency."[48] More specifically, the agency is given the authority to take actions to prevent "unfair," "deceptive," or "abusive" practices in connection with a consumer financial product or service as defined by the agency.[49] While there is a substantial body of consumer protection jurisprudence interpreting the terms "unfair" and "deceptive," the introduction of the heretofore undefined term "abusive" suggests that the CFPA will be substantially broader than traditional state level consumer protection legislation.

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[46] New Foundation, *supra* note 1, at 66.
[47] LACKO & PAPPALARDO, *supra* note 39, at ES-12.
[48] CFPA Act, *supra* note 2, at § 1002(31).
[49] *Id*. at § 1031.

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B. Federal Regulatory Overlap and Inconsistencies

Of primary concern is the distinguishing of the CFPA's consumer protection mission from the Federal Reserve's safety and soundness regulatory authority. Under the White Paper's proposal, the CFPA would have authority to enforce regulations and impose substantial financial penalties. Inevitably, this power to impose financial penalties will threaten the financial condition of banks, thereby bringing the CFPA into conflict with the safety and soundness regulatory authority of the Federal Reserve.

The CFPA would attempt to carve off the regulation of consumer financial products and services from all other consumer protection agencies. Scholars and policy-makers have long recognized that governmental bureaucracies are prone to "tunnel vision," especially those bureaucracies defined by the substantive sector that they regulate rather than by their function. Such agencies are prone to interest-group capture that undermines their effectiveness. Instead of creating a new bureaucracy, Congress instead should consider expanding the jurisdiction of the Federal Trade Commission and strengthen the Federal Reserve to meet the discrete categories of true consumer protection issues that arise under current law. The FTC has longstanding expertise in consumer financial protection issues as well as related areas of consumer information, labeling, and advertising. In particular, Congress should consider the FTC's study of consumer disclosure regulations which provides numerous useful recommendations for improving consumer disclosures in a more user-friendly (and less lawyer-friendly) manner. As currently articulated by the CFPA Act, the CFPA creates a significant risk that the expertise of the Federal Trade Commission and its influence on judicial interpretation of vague terms like "unfair" and "deceptive" to ensure that the terms are interpreted in a

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manner consistent with the public interest and consumer welfare, will be eliminated. Historically, the Federal Trade Commission has imposed important restraints on the judicial interpretation of state consumer protection legislation.[50] This monumental shift in authority, without any constraint that CFPA interpretations harmonize with those at the Federal Trade Commission, may be problematic. For instance, unhinged from Federal Trade Commission interpretations, lending practices might be found "abusive" without an actual demonstration of consumer harm or that enforcement is in the public (consumer) interest.[51]

C. State Regulatory Overlap and Inconsistencies

The CFPA Act of 2009 eliminates the federal preemption of consumer protection regulation of nationally chartered financial institutions.[52] It specifically allows and encourages the states to adopt more stringent regulations than those adopted by the CFPA itself.[53] The Treasury Department's *Financial Regulatory Reform* plan seems to suggest even further that the CFPA will encourage state enforcement actions.[54]

As discussed above, the new agency does not have to follow the Federal Trade Commission jurisprudence concerning which practices are "unfair or deceptive" under Section 5 of the FTC Act.[55] It also leaves the term "abusive" undefined and simply

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

[51] For an explanation as to harm requirements and other questions in the construction and application of consumer protection acts, *see generally* Victor E. Schwartz & Cary Silvermann, *Common Sense Construction of Consumer Protection Acts*, 54 U. KAN. L. REV. 1 (2005).

[52] CFPA Act, *supra* note 2, at § 1041(a)(1).

[53] *Id*. at § 1041(b).

[54] New Foundations, *supra* note 1, at 50-51.

[55] CFPA Act, *supra* note 2, at § 1031(c). Specifically, the proposed Agency merely need "consider established public policies as evidence to be considered with all other evidence" in concluding whether or not a given business practice is "unfair" under the CFPA Act. *Id*. At least one Federal Trade Commissioner has expressed concerns about this feature of the CFPA. *See* William E. Kovacic, Statement on the Proposal to Create a Consumer Financial Protection Agency to the Committee on Energy and

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authorizes the new agency to take any action to "prevent a person from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service."[56] When read in conjunction with the CFPA Act's encouragement for states to adopt even stricter sets of regulations for financial products and services, and undefined terms such as "abusive" practices, it becomes likely that we observe highly variable state law develop through statute and judicial interpretation regarding consumer protection in lending markets. The vagueness of the standard, the fact that it is unconstrained by either FTC jurisprudence or expertise concerning consumer protection, and the likely variance between state regulations will raise the costs of litigation to lenders because these factors will expand lenders' potential liability to some undefined, broader range of circumstances. These increased costs will, in turn, result in higher prices for consumers without any demonstrable offsetting benefits in the way of increased consumer protections.

The CFPA is an idea that begins with a mistaken understanding of the causes of the financial crisis. The problem is only compounded by granting unbounded powers to regulate and design financial products and services to an agency without any expertise at the expense of at least one that does, all while encouraging states adopt even more stringent rules. If one looks to the proposed set of "behaviorally informed" regulations likely to be proposed by the CFPA, we predict that competition and consumer choice in

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Commerce and the Committee on Financial Services (July 28, 2009), *available at* http://www.ftc.gov/speeches/kovacic/090728stmtrecord.pdf. Commissioner Kovacic notes that "conflicts in interpretation and in litigation strategies, along with an increase in litigation over jurisdictional questions, will adversely affect every core area of consumer protection for which the FTC will continue to exercise primary responsibility." *Id*.

[56] CFPA Act, *supra* note 2, at § 1031.

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these markets will decrease, product variety and innovation will fall, access to credit for disadvantaged consumers will be restricted, and the cost of this “consumer protection” experiment will fall disproportionately on those it was designed to protect.

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