
FINANCIAL SERVICES & E-COMMERCE

THE CONSUMER FINANCIAL PROTECTION BUREAU AND THE RETURN OF PATERNALISTIC COMMAND-AND-CONTROL REGULATION

By *Todd J. Zywicki*

I. THE RETURN OF COMMAND-AND-CONTROL REGULATION AT THE CONSUMER FINANCIAL PROTECTION BUREAU

A centerpiece of the Dodd-Frank financial reform legislation was the establishment of the Consumer Financial Protection Bureau (CFPB), a new consumer protection super-regulator with the power to control the terms and offerings of every consumer financial product in America, from expensive complex mortgages offered by trillion-dollar international banks to short-term small-dollar loans by local payday lenders and routine debt collection. Moreover, because many small and start-up businesses are funded by the entrepreneur's personal credit, the CFPB has effectively become the regulator of much of the economy's small business credit as well. The White House press release issued contemporaneously with the CFPB's March 2015 announcement of plans for new stringent regulations on payday lending summed up: "One of the most critical components of the Wall Street Reform bill passed by Congress in 2010 and signed by the President was the creation of the Consumer Financial Protection Bureau (CFPB), a dedicated, independent cop on the beat with the single goal of protecting consumers from threats like abusive practices of unscrupulous lenders or the fraudulent practices of debt collectors."¹

II. AGENCY RULES AND APPROACH

According to its own materials, the CFPB touts itself as a "21st century, data-driven agency,"² and its proponents argue that it will take a "market-based approach" to regulation, seeking to make markets work better instead of replacing markets, through product bans, substantive regulation of specific terms of contracts, and the like.³ In practice, however, the CFPB has quickly evolved into an old-fashioned command-and-control paternalistic regulator. Moreover, as a result of the combination of the CFPB's extremely broad authority and a lack of accountability from traditional oversight by the President or Congress, the CFPB's archaic regulatory approach holds potential for extreme harm to consumers and the economy. Its adoption of discredited command-and-control regulatory strategies is especially tragic in that, prior to Dodd-Frank, the federal system of consumer financial protection was in dire need of reform. Consumer financial regulation should have been systematized and modernized in light of sound economics and a more institutionally streamlined and coherent regulatory approach that could not only unify federal consumer financial protection policy, but also encourage federal and state policies to work together more effectively for the benefit of consumers. Instead, the CFPB's approach resembles a Nixon-era regulatory

dinosaur frozen in ice and thawed out to try to regulate our 21st century economy.

III. CONTEXT: CONSUMER FINANCIAL PROTECTION REGULATION: OLD AND NEW APPROACHES

While legal rules governing the U.S. economy broadly support freedom of contract, the CFPB's command-and-control approach is more consistent with the historical approach of consumer financial protection law, which was defined by substantive regulation of terms and conditions of consumer financial products. Most notably, regulators around much of the world long regulated the maximum allowable interest rates for consumer credit products under "usury" laws that prohibited rates of interest regulators deemed excessive, purportedly to protect low-income and improvident borrowers from excessive costs and use of credit.⁴ Following Jeremy Bentham's criticism of price controls on interest rates in the eighteenth century, however, a consensus emerged among economists that price controls on interest rates harmed consumers by forcing lenders to adjust other terms of the contract (such as requiring larger down-payments or larger loan amounts), by distorting the consumer credit market (favoring retailers that could increase prices of goods to offset credit losses), and by reducing credit availability to higher-risk borrowers (which increased their dependence on loan sharks and lower-quality credit products such as pawn shops). Apart from their inefficiency, usury ceilings' ill effects fall hardest on their supposed beneficiaries—low-income consumers—who are the first to lose credit choices when regulation tightens access to credit. Economic analysis has stressed that the distorting effects of command-and-control regulation of terms applies not just to regulation of interest rates but to restraints on any freely-bargained term of a consumer credit contract.

This recognition of the failure of command-and-control regulation led to a movement in the 1960s and 1970s toward disclosure requirements in place of substantive restrictions on products and terms, best exemplified by the enactment of the Truth in Lending Act. Disclosure regulation rests on the presumption that, rather than dictating terms and conditions of credit, regulators should try to work within the market structure by providing standardized disclosure formats and similar tools that will enable consumers to comparison shop among different providers of credit. This vision of disclosure regulation, however, fell victim to litigation, regulatory excess, and a preference for disclosure rules intended to shape consumer behavior rather than disclosure requirements that enable informed consumer choice.

The CFPB's resuscitation of a command-and-control approach to regulation is a self-conscious return to the regulatory approach of the past. The CFPB, as proposed by now-Senator Elizabeth Warren and others, was modeled on

* *Todd J. Zywicki is George Mason University Foundation Professor of Law at George Mason University School of Law and Executive Director of the Law & Economics Center at George Mason University School of Law.*

the Consumer Products Safety Commission, which has the power to ban and recall consumer products deemed to be “unsafe.” Indeed, in advocating for the new agency, Warren once expressly analogized the regulation of subprime mortgages to unsafe toasters that explode when used, oblivious to the obvious differences between the products.⁵

Although the CFPB is expressly barred by Dodd-Frank from setting interest rate ceilings, its archaic approach to consumer financial protection is seen in a variety of other substantive areas. For example, its “Qualified Mortgages” and “Ability-To-Repay” rules essentially dictate the mortgage terms and borrower conditions which it deems to be “safe” mortgages for consumers. Yet at the same time, the rules do nothing to address the primary cause of the foreclosure crisis—the prevalence of underwater mortgages that provided consumers with an incentive to default when their homes fell in price—such as by requiring larger down payments, limiting cash-out refinancing, or recognizing the effects of state anti-deficiency laws that limit a borrower’s personal liability upon mortgage default. The CFPB is also proposing rules on payday loans, auto title loans, installment loans, and other products that would force lenders to assess a borrower’s ability to repay small-dollar loans before extending them, essentially eliminating (or sharply curtailing) those products from the marketplace.⁶ With respect to auto loans issued by auto dealers, the CFPB is using its leverage over banks to try to restrict the opportunity for borrowers to negotiate over loan terms, because bargaining ability may result in pricing differences that have disparate impact on borrowers. Although enacted prior to Dodd-Frank, the Credit CARD Act of 2009 similarly regulates the terms of credit card accounts, such as limiting the size and incidence of certain behavior-based fees and limiting the ability of issuers to reprice interest rates when consumers’ credit risks change.

The CFPB also appears prepared to take steps that would nullify pre-dispute arbitration clauses in consumer credit contracts, thereby opening the market to increased class action litigation. The “Durbin Amendment” to the Dodd-Frank financial reform legislation places price controls on the interchange fees of debit cards issued by banks with over \$10 billion in assets, cutting those fees approximately in half and reducing bank revenues by an estimated \$6-\$8 billion annually. Finally, although the CFPB is barred from fixing interest rate ceilings, the Department of Defense has been authorized to do so with respect to members of the military, and it has extended the terms of the Military Lending Act to apply its 36% interest rate ceiling to virtually every consumer credit product used by military members.

IV. EFFECTS OF COMMAND-AND-CONTROL REGULATION FOR AMERICAN CONSUMERS

The effects of the command-and-control approach to consumer financial protection have been disastrous for consumers. For example, studies have found that implementation of the CARD Act accelerated interest rate increases on all credit card accounts and reduced access to credit cards (which has since fallen by 11 percent among low-income households). The Qualified Mortgages rule slowed recovery of the housing market by creating a massive layer of regulatory red-tape and liability risk for banks. And, despite the CFPB’s

pledge to examine the cost and availability of alternative sources of short-term credit for consumers before imposing new restrictions on payday loans, the CFPB appears ready to force these products out of the market without any evident replacement for the millions of Americans who rely on them to make ends meet. The problems visited on consumers are not entirely attributable to administrative decisions; for instance, large banks facing massive revenue losses from the Durbin Amendment have compensated with more and higher bank fees on consumers—free checking accounts have shrunk from 76% of all bank accounts to only 38%, and fees on bank accounts, such as monthly fees and overdraft fees, have risen substantially. This loss of access to free checking has been particularly problematic for low-income consumers who cannot afford the higher fees or the higher minimum balances necessary to avoid those fees. According to the FDIC, the number of unbanked American consumers rose by 1 million from 2009-2011, and the number of underbanked consumers rose even more, in part because of their loss of access to mainstream financial products as a result of the Durbin Amendment, the CARD Act, and various regulations.

In addition, the regulatory weight of the CFPB has tilted retail banking markets against smaller banks that cannot afford the new regulatory compliance costs associated with its many regulations and litigation risk. A study by the Mercatus Center at George Mason University found that 71% of small banks stated that the CFPB has affected their business activities.⁷ Sixty-four percent of small banks reported that they were making changes to their mortgage offerings because of Dodd-Frank, and 15% said that they had either exited or were considering exiting residential mortgage markets entirely. Nearly 60% of small banks reported that the CFPB and/or the Qualified Mortgages rule had a “significant negative impact” on their mortgage operations. More than 60% said that changes in mortgage regulations had a significant negative effect on bank earnings. Driving smaller banks from the market reduces competition and consumer choice, hurting all consumers; moreover, community banks serve a particularly crucial role in smaller, rural communities, making their loss particularly painful for those consumers and small businesses.

This kind of regulation also stifles innovation and creativity. For example, the Qualified Mortgages rule forces all mortgages into a one-size-fits-all set of underwriting criteria. In so doing, the rule has deprived community banks of their one competitive advantage against megabanks: their intimate familiarity with their customers and their ability to engage in relationship lending with their customers and to tailor loans to the needs of their customers. Similarly, the Durbin Amendment applies to prepaid cards issued by covered banks if those cards provide a level of functionality comparable to bank accounts; this shadow of the Durbin Amendment has deterred the largest banks from developing low-cost, no-frills prepaid and mobile bank products that could provide an alternative to expensive bank accounts for lower-income consumers.

V. WHAT SHOULD BE DONE

America’s consumer financial protection regime was in need of an overhaul prior to Dodd-Frank. Instead of updating the regime, the CFPB is attempting to impose 19th century

regulatory approaches on a 21st century consumer credit economy. Consumers today have unprecedented choice, flexibility, and information about the products and services that they use. Consumer credit is no exception.

A modern regulatory strategy would begin with understanding the success of market economies, especially that of the United States, identifying the particular market failure the regulator seeks to address, and then designing crisply tailored regulation that addresses the problem with a minimum of unintended consequences. Many prior bases for regulation have been obviated or reduced in the modern world. For example, there are multiple credit card comparison websites (such as cardhub.com) that compile and assess the various terms of credit card offers and enable consumers to shop for cards according to the terms that they find most valuable, including interest rates, rewards, and even particular terms like fees on foreign transactions. Credit card issuers recognize the vast heterogeneity of credit card customers and tailor their products to the needs of consumers. These comparison websites have arisen to help consumers find the particular card offerings that they want. In this context, heavy-handed regulation is both unnecessary and detrimental.

For products such as payday loans, concern about vulnerable consumers with limited options are understandable, but regulatory solutions that further deprive these consumers of choices often harm those consumers that the regulations are purportedly intended to help. Surveys of payday loan customers reveal that they fully understand the terms and price of their choices; there is no compelling evidence that users of these products would be better off without such loans. Although the evidence is mixed, studies suggest that banning payday loans leads to more bounced checks and greater use of overdraft protection (which is often more expensive than payday loans) and may lead to more evictions and utility terminations.

The centerpiece of a modern consumer financial protection regime should be focused on encouraging competition, consumer choice, and innovation. Command-and-control regulation of consumer financial products, from the Durbin Amendment to new proposed regulations on payday loans, will have the opposite effect—reducing choice, competition, and innovation. Perhaps most tragically, these regulations typically fall hardest on the most vulnerable American consumers, taking away choices from those consumers who already face limited choices as a result of their situations in life. Ill-considered regulations are driving mainstream financial products such as credit cards and bank accounts out of the reach of low-income consumers, pushing those consumers into the alternative financial sector of check cashers, pawn shops, and payday lenders. As has happened so often in the past, paternalistic regulations intended to help consumers end up hurting them.

Endnotes

1 White House, *Progress Toward Building a Safer, Stronger Financial System and Protecting Consumers from Unfair and Abusive Practices* (March 26, 2015), <https://www.whitehouse.gov/the-press-office/2015/03/26/fact-sheet-progress-toward-building-safer-stronger-financial-system-and->

2 Consumer Financial Protection Bureau, *CFPB Releases Report Showcasing 2012 Highlights* (July 30, 2012), <http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-releases-report-showcasing-2012-highlights/>.

3 Patricia McCoy, Leonard Kennedy, & Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the 21st Century*, 97 CORNELL L. REV. 1141 (2012).

4 For a discussion of the history and economic analysis of usury laws, see THOMAS A DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, AND TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY at Chapter 11 (2014).

5 See Stefanie Haeffele-Balch and Todd Zywicki, *Loans are not Toasters: The Problems with a Consumer Financial Protection Agency*, Mercatus on Policy No. 60 (Oct. 2009).

6 According to one estimate, over 80% of small non-bank lenders would be wiped out if the CFPB's small-dollar lending proposals were adopted. See Arthur Baines, Marsha Courchane, and Steli Stoianovici, "Economic Impact on Small Lenders of the Payday Lending Rules under Consideration by the CFPB" (Prepared for: Community Financial Services Association of America Prepared by Charles River Associates), available at <http://www.crai.com/sites/default/files/publications/Economic-Impact-on-Small-Lenders-of-the-Payday-Lending-Rules-under-Consideration-by-the-CFPB.pdf> (May 12, 2015).

7 Hester Peirce, Ian Robinson, and Thomas Stratmann, *How Are Small Banks Faring Under Dodd-Frank?* Mercatus Center Working Paper No. 14-05 (Feb. 2014).

