

Sea Changes in Consumer Financial Protection

Stronger Agency & Stronger Laws
Dee Pridgen
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What Led to New Legislation?

- * Financial Crisis of 2007-08
- * Subprime foreclosures, housing bubble burst
- * High consumer credit card debt, complaints re excessive “tricks and traps”
- * High unemployment combined with consumer debt – debt collection abuses

New Federal Laws

- * Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010
- * New agency – Consumer Financial Protection Agency or CFPB
- * Mortgage Reform & Anti-Predatory Lending Act
- * Credit CARD Act of 2009

Structural Flaws in Consumer Financial Protection

- * Consumer financial protection spread out over several bank regulatory agencies & FTC – no one agency had deep expertise
- * Bank agencies had conflicting mission and FTC had no jurisdiction over banks
- * Banks could shop around for more favorable federal agency and more favorable state/federal laws, resulting in “race to the bottom”

Sea Change – Stronger Agency

- * CFPB consolidated consumer protection divisions of existing bank agencies & has concurrent jurisdiction with FTC
- * CFPB focus is solely on consumer protection, has jurisdiction over all relevant entities and credit products “under one roof”
- * Dodd-Frank eliminated most federal preemption of state consumer protection law to eliminate shopping for better law

CFPB More Powerful Than FTC

- | CFPB | FTC |
|---|--|
| * Created in 2010, opened doors in 2011 | * Created in 1914, consumer protection mission 1938 |
| * Housed w/n Fed Reserve, funded by FRB revenues | * Funded by Congress |
| * Run by single director | * Run by 5 commissioners |
| * Authority over deceptive, unfair <u>and</u> abusive financial practices | * Authority over deceptive or unfair trade practices |
| * Notice & Comment rulemaking | * Magnuson-Moss rulemaking |

“Homo Economicus” v. Real Humans

Homo Economicus

- * Rational consumer will maximize own welfare by making rational choices based on disclosures of relevant information
- * Rational Choice Theory was basis of last wave of consumer protection law – Truth in Lending Act

Real Human Beings

- * Behavioral economics studies (1990’s & 2000’s) show cognitive barriers to rational consumer choice
- * Behavioral economics is basis of new wave of consumer protection law

Why Disclosures Did Not Prevent Financial Crisis

- * “Information overload” – complex terms
- * Consumers are overly trusting of brokers/lenders
- * Consumers are “myopic” - focus on salient items
- * Consumers are overly optimistic
- * “Hyperbolic discounting” makes teaser rates more persuasive
- * “Back-end” fees are not factored into decision

Sea Change – Stronger Laws

- * In 2009-2010, Congress changed course in areas of residential mortgage laws and credit card laws due to shortcomings of pure disclosure approach
- * New laws contain more substance as well as improved disclosures based on consumer research
- * Substantive approach provides minimum standards of fair dealing while preserving market choices

Mortgage Reform Act – Better Disclosures

- * “Know Before You Owe” – CFPB combines two confusing disclosures from two agencies into one more readable document
- * <http://www.consumerfinance.gov/knowbeforeyouowe/>
- * APR from TILA disclosure now on page 3, TILA and RESPA disclosures will be merged

Mortgage Reform Act – More Protections for Consumers

- * Universal requirement of consumer “ability to repay” as a condition for all residential mortgages
- * Ban on mortgage brokers steering consumers into unfavorable loans and on accepting “yield spread premiums” as compensation
- * Strict limits on prepayment penalties
- * Other provisions including ban on single premium credit insurance, ban on pre-dispute mandatory arbitration clauses & appraisal independence requirements

Ability to Repay Required

- * Lending based on collateral rather than income, brokers working for commission, and lenders who resell to investors, were all factors that resulted in loans made that consumers could not repay
- * Universal requirement of consumer “ability to repay” is now a condition for all residential mortgages;

Yield Spread Premiums

- * New federal law bans brokers from accepting “yield spread premiums” (YSP) as compensation
- * YSP is a form of broker compensation that is paid by the lender directly to the broker in return for the broker obtaining an interest rate on the loan that is higher than what lender would have accepted from that borrower
- * YSP leads consumers to pay higher interest rates than they need to

Prepayment Penalties

- * Strict limits on prepayment penalties, limited in amount and duration, or banned altogether
- * Prepayment penalty is just what it sounds like, borrower pays extra if they want to pay off early, e.g., by re-financing
- * Penalty is meant to compensate lender for their lost expected income on the loan
- * Prepayment penalties, especially if they extend for long periods of time, tend to discourage people from paying off bad loan and refinancing

Credit CARD Act of 2009 – More Protection for Consumers

- * Credit card debt escalation due in part to “tricks & traps” exploited by card issuers
- * Examples – teaser rates & rate-jacking, late fees, penalty rates, over-the-limit fees, unfair billing practices and excessive marketing to young consumers
- * Congress opted for better disclosures plus more minimum protections for consumers

CARD Act Protections - Rates

- * Creditors must provide at least 45 days’ notice of rate increases and may not charge an increased rate to prior balances;
- * “Teaser” or promotional rates must last at least six months;
- * Creditors may not increase rates based on consumer’s payment pattern in connection with other accounts (“universal default” banned);
- * If rate is increased due to default or late payment, creditor must reinstate normal rate after six months of on-time payments

CARD Act Protections - Billing

- * Ban on “double-cycle billing” which eliminated free ride if bill not paid in full
- * Consumer payment must be applied first to balances w/ higher rates; mail bills 20 days before due date; due date must be same every month; cutoff must be no earlier than 5PM
- * Card issuer must provide minimum payment disclosure showing payoff time and total amount paid if only minimum payment is made

CARD Act Protections - Fees

- * Penalties and fees must be “reasonable and proportional” to omission or violation (under regs, most late payment fees limited to \$25 or \$35 and over-limit fees capped at \$35)
- * Over-the-limit fees must be expressly elected by consumers
- * Fees can’t be more than 25% of available credit in 1st 12 months (no “fee harvester” cards);

CARD Act Protections – Young Consumers

- * Consumers under 21 cannot be issued credit cards unless
 - * they have a co-signor who is 21+ or
 - * they show they have independent means of repaying the obligation

CARD Act & Young Consumers: Pro & Con

- * Young consumers needed special protection because they were being targeted aggressively by credit card issuers when most of them were not financially responsible
- * Under-21 protections are not going to be effective because card issuer can look at ability to repay min. payment, and can look to sources of income in future, like seasonal work; also co-signor provisions allow slightly older college friends to co-sign
- * Protections for under-21 consumers is contrary to prevailing law of majority for most other contracts (18), and will cut off important source of credit for young entrepreneurs

Sea Changes in Consumer Protection: Are They Good or Bad?

- * Rational consumer choice theory is based on consumer sovereignty; use of behavioral economics means government makes the choice, “new paternalism”
- * The use of specific substantive provisions is “whack-a-mole” form of governing – same problem will spring up in different form
- * Additional regulation will impose unnecessary costs & shrink supply of credit
- * CFPB is too powerful, lacks sufficient Congressional oversight and has too broad & ill-defined mission

Sea Changes in Consumer Protection: Are They Good or Bad?

- * Behavioral economics theories seem more realistic than rational consumer choice theory
- * New approach addresses the balance of power between consumers who are hampered by cognitive barriers & marketers who study human behavior and may exploit weaknesses
- * Benefit of preventing abuse of consumers & preventing future financial crisis outweighs cost of regulation
- * CFPB empowered to deal with unforeseen future problems, & structured to weather future storms