Rebalancing Consumer Protection in the Trump Era

By Ingo Walter

Before and after enactment of the Dodd-Frank legislation in 2010, concerns were raised that consumers often lacked the knowledge to evaluate and make informed decisions about important financial services. In the past, the government and employers often made some of the most important financial decisions on behalf of households—for example by providing Social Security or defined-benefit employee retirement plans. Today, households are mostly on their own when it comes to home mortgages, car loans, asset management, retirement planning, household credit for major durable purchases and credit lines for ongoing household expenses, life and nonlife insurance to keep a family secure, and many more such services.

On the plus side, there are plenty of financial products and competitors from all kinds financial firms to choose from. But over time, financial products have become more complex and less transparent, and there is a bewildering range of options to wade through. Often, financial salespeople are under heavy pressure to cross-sell, leading to unneeded new accounts or up-sold services, sometimes attached to an array of imbedded and sometimes-undisclosed fees. Certain products, such as some kinds of variable annuities, can be almost impossible for consumers and even salespeople to value and identify the associated risks.

Back in the glory days of the mortgage boom a decade ago, eager households were offered mortgage “affordability” resets, imbedded options and prepayment penalties. The financial crisis soon placed many of these issues in sharp relief in the U.S. housing market’s mortgage-origination “fee machine” and, through financial contagion, its contribution to global systemic risk.

In a recent paper,[145] Harvard University's John Campbell addressed how consumers can make more rational financial choices in home purchases, retirement savings, paying for higher education and other major decisions when navigating the fog of modern finance compounded by financial ignorance. He summarized the key issues as lack of financial education, naiveté, overconfidence and inattention to detail, to which can be added lethargy and sloth. The results take the form of both real costs imposed on household by mistakes and opportunity costs that could have been avoided—and which in a broader context may be associated with the much-discussed pattern of income and wealth distribution in the United States.

The question is whether greater financial disclosure and transparency—together with financial education and vigorous enforcement of laws to ensure fair dealing and block financial bad actors—will help level the playing field. Examples include easy-to-understand choice options and target-date mutual funds in retirement plans—features that focus on transparency, costs and risk profiles. But Campbell also points out that uniform regulations that effectively raise costs do so on all households, whether or not there are benefits in overcoming financial disadvantages.

As in any market, there are buyers and sellers, and it's in the interest of both to come to market fully informed about the price and the exact terms of what is being bought and sold. There are always mistakes being made, but the playing field should be as level as possible for the market to do its work: wealth creation, rather than wealth redistribution.

The argument for regulatory intervention is that consumers frequently suffer from market attributes that are stacked against them, so that *caveat emptor* is an inappropriate model

[145] "Restoring Rational Choice: The Challenge of Consumer Finance," American Economic Association, 2016 Richard Ely Lecture, 3 January 2016.

for conduct in the retail financial marketplace. Many factors can account for consumers finding themselves at a disadvantage, including lack of education and financial skills, lack of transparency in financial products and services, lack of fiduciary responsibility on the part of financial services vendors, and exploitation of vendor conflicts of interest.

Few would argue that consumers should escape the need for proper due diligence, or not bear some accountability for their own errors. Moral hazard alone makes an excessively robust consumer safety net untenable. There should be plenty of holes in the safety net. But a systematically biased playing field that aggressively steers consumer choice, provides incomplete and biased information, and creates conditions of financial exploitation is no less toxic. It drains *trust* from the system. Without trust, neither financial efficiency nor stability can be assured; it ultimately encourages excessive regulation when the political costs get too high. So there is a legitimate argument that both remedial and preemptive improvements in some key dimensions of consumer finance are a good idea.

First, consumers need to be financially literate in order to make well-informed choices in complex financial decisions. There have been some severe gaps. Consumers often do not understand fundamental financial conceptssuch as compound interest, risk diversification, real versus nominal values, and even the difference between stocks and bonds. Indeed, the evidence suggests that consumerswith higher levels of financial literacy plan better for retirement, while those with lower levels of literacy borrow more, save less, and have more trouble repaying their debts, making ends meet, planning ahead, and making important financial choices.

Realistically, who’s going to cut down on time devoted to their jobs and recreational priorities to take Adult School classes in basic finance? And sometimes *too much* information is provided and leads to information overload, which can cause consumers to focus on only a few pieces of easily understood information, not necessarily the key aspects for complex financial decisions.

There are, of course, counter-examples. One is lapsed life insurance that can be surrendered with total loss of capital, sold back to the insurance carrier at a substantial discount, or sold to third parties for securitization and marketed to investors—sometimes called "death bonds" or "mortality bonds." Another example is long-term care insurance, which can be an expensive but rational choice for consumers, or a combination of life insurance and long-term care insurance to lower the cost. Consumers sometimes seem to display remarkable clarity in thinking about the options, even though pricing and disclosure specifics may remain obscure.[146]

Still, consumers can be overly optimistic in interpreting information in a way that helps lead them to a desired, if irrational, conclusion. And there's concern that some financial firms purposely design and proactively advertise products to mislead consumers about benefits, leaving "financial health warnings" to the fine print. Some classes of consumers—such as older people preoccupied with life's other challenges, minorities and women—may be particularly vulnerable to aggressive marketing practices for financial products and thus exploitation. It has been argued that complex financial products survive in the marketplace because they enable cross-subsidizing sophisticated consumers at the expense of the unsuspecting. Regulatory intervention in that context will tend to redistribute income away from sophisticated customers, who prefer less consumer protection.

The underlying argument is that fairness embodies more than moral or ethical content in the financial architecture. Failure to provide equitable treatment undermines confidence in the system

[146] Paul Sullivan, "Life Insurance Plus Long-Term Care? Run the Numbers First," *The New York Times*, December 10, 2016.

and impacts liquidity, efficiency and growth. It distorts financial flows on the part of ultimate sources and uses of funds, and undermines the political legitimacy of financial intermediaries and those who regulate them. So sensible government intervention is needed as a matter of the public interest.

Dodd-Frank and the Consumer Financial Protection Bureau

This is the logic behind the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which created the Consumer Financial Protection Bureau (CFPB) as an independent unit within the Federal Reserve System. Dodd-Frank was mainly about financial stability and systemic risk. But "consumer protection" in the title signaled its political centrality in setting out the future rules of engagement.

Dodd-Frank's consumer protection legislation covers depository institutions with assets exceeding $10 billion, mortgage lenders, mortgage servicers, payday lenders, and private education lenders. It does not cover automobile financing.

The legislation created the CFPB with a mandate to aid consumers in understanding and using relevant information. Its intent was to shield them from abuse, deception, and fraud by ensuring that disclosures for financial products were easy to understand. It is also mandated consumer finance research and financial literacy education. It has the authority to set rules under existing consumer financial law and take appropriate enforcement action to address violations. It is charged with collecting, investigating, and responding to consumer complaints. And it has a mandate to ensure that suitable financial products andservices are made available to consumer segments and communities that havetraditionally been underserved.

The CFPB is an entity of the Federal Reserve System, and its budget is self-determined and funded out of Fed resources, not by Congressional appropriation, thereby offering some protection against inevitable lobbying pressure. It is managed by a Director (currently Richard Corday) who is appointed by the President with the advice and consent of the Senate, serving a five-year term and who (like that Chair of the Federal Reserve Board) can be dismissed only "for cause."

The Financial CHOICE Act

The consumer protection provisions of Dodd-Frank and the CFPB were controversial from the start, with criticism spanning a range of issues from the constitutionality of its mandate and the heavy hand of overregulation to the "blank check" funding through the Fed and the early cases demonstrating its allegedly excessive use of enforcement powers. Much of the criticism was concentrated in the draft Financial Choice Act tabled by Republicans on the House Committee on Financial Services in June 2016. There are two major themes in this proposed CFPB revision:

The first is governance and accountability. As a unit of the Federal Reserve System, CFPB governance was considered both indirect and lacking a clear public mandate and political accountability. Moreover, its budget (close to $1 billion in fiscal 2016) thought to escape the kinds of checks and balances that apply to other Federal agencies. The CHOICE Act would broadly extend to the CFPB the kinds of governance, accountability and budgetary appropriations that apply to other Federal agencies.

The second key issue is consumer choice and cost. The CFPB is thought to preempt free consumer choice, transferring key decisions—such as which financial products will be available and to whom, what product information needs to be disclosed, and how they are marketed and priced—to CFPB bureaucrats. The argument is that the CFPB has reflected a retrograde shift from the market economy toward increased paternalism of the state. It highlights presumptive cuts in access to financial services to the 'un-banked' and 'under-banked,' increases in the cost of financial services, violates consumer privacy, and harms small businesses that rely on consumer financial products.

That said, convincing empirical evidence suggests that tough consumer protection measures can, in fact, work. Take for example the 2009 Credit Card Accountability and Responsibility and Disclosure (CARD) Act, which capped credit card penalty fees that card issuers were using to make up for lost revenues during the recession.[147] A careful study of the CARD Act's impact finds that the reduction in fee revenue from cancelled "over-limit" and late fees did not lead to banks' increasing credit card interest rates or significantly raising other fees in the period through 2015—nor did it reduce access to credit for U.S. households. In combination, the Act cut the cost of financial services to consumers by about $11.6 billion annually.[148]

The Financial CHOICE Act proposes a range of specific reforms that would fundamentally change the operations, governance, accountability, and funding of the CFPB, although it does not propose to scrap it. Nor does it seem to be true that the CFPB has been out of control in pursuing its mandate, since it was created by the Dodd-Frank Act. In reviewing the record so far, John Campbell concludes, "The CFPB has produced a relatively small number of major new rules through a deliberate process. In 2013 a rule took effect requiring fee disclosures in remittance transfers to foreign

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[147] The credit card industry levied $11.4 billion in penalty fees in 2015, about half the amount levied prior to the CARD Act and imposition of CFPB fee limits. In the United States, about 170 million credit card accounts (20% of the total active accounts) incurred late fees in 2015. Robin Sidel, "AmEx Raises Fee for Late Payers," *Wall Street Journal*, November 26, 2016.

[148] Agarwal, Sumit, Souphala Chomsisengphet, Neal Mahoney and Johannes Stroebel, "Regulating Consumer Financial Products: Evidence from Credit Cards." *Quarterly Journal of Economics* (2014) 130 (1): 111-164.

countries; in 2014 a rule defined the standards that lenders must use in assessing borrowers' ability to repay mortgages, and the standards for qualified mortgages that, under the Dodd-Frank Act, provide greater protection against litigation to lenders who issue them; in 2015 a rule took effect integrating and simplifying the disclosure forms that mortgage borrowers receive; and in 2016 the CFPB issued a rule scheduled to take effect in 2017 regulating the terms of prepaid cards. The CFPB has sought comments on proposed rules concerning arbitration in consumer financial disputes and the terms of payday lending. None of the rules currently in effect are plausibly responsible for major changes in the availability of household credit."[149] In his view, the CFPB's complaints registry and data collection are, themselves, a valuable contribution to a more level consumer finance playing field.

Where Should the Trump Administration Be Heading?

Where the Trump administration will come down on consumer financial protection and the fate of the CFPB and the Financial CHOICE Act is uncertain at this point. But at least the FCA offers a considered roadmap for change, one that deserves to be debated. It seeks to pare away some of the Dodd-Frank provisions considered superfluous or counterproductive, and increase the accountability and budgeting process of the CFPB to align it with governance of other important Federal agencies—all while increasing accountability to elected officials.

It is hard to argue against political accountability and financial discipline. Still, in a system driven by heavy lobbying and financial contributions by those who stand to gain or lose from consumer protection measures, the survival and impact of Financial CHOICE Act proposals, if enacted, are difficult to gauge. It is a major, highly complex exercise in cost-benefit analysis—one in which both costs

[149] John Campbell. "Consumer Protection in Need of Protection," at **http://econofact.org/consumer-financial-protection-in-need-of-protection**. February 2017.

and benefits are often obscure, and second-best solutions are welcome. Inserted into the coming overheated, lobbyist-driven political debate, it is not hard to imagine that consumer interests will once again come at the end of the line.

Of course, there is always the threat of overregulation, but there is also value in helping consumers gain financial literacy, in improving our understanding of how consumer financial markets work, in helping people access and use relevant information, and in protecting them from abuse, deception and fraud.

Fintech—shorthand for financial technology—is the wild card in the game. Several dozen competitors are now in the game and range from start-ups and proof-of-concept players to established survivors seeking “unicorn” status by disrupting a retail financial services industry that is considered overdue for disruption. Services range from marketplace lending to robo-advising, from financial aggregation to retail remittances, from e-brokerage to e-retirement planning. As these “direct-connect” linkages take root, some of the key household disadvantages in finance could melt away—especially as new generations of consumers enter the market—so that the case for consumer finance regulation may weaken.

On the other hand, the legacy players are sophisticated, and many fintech initiatives have already been internalized by the established financial intermediaries. Even the independent “disruptors” themselves have found it opportune to link up with fintech upstarts in joint ventures and as attractive acquisition targets. The fintech dynamic has its own ways of tilting the playing field and generating new forms of conflicts of interest. Good news or bad news? Some of both, no doubt, and time will tell. What is certain is that consumer financial protection will be a moving target and take on new forms.

What’s also certain is that there will continue to be many “sticky fingers” in finance, amply reflected in the waves of wholesale and retail banking scandals since the financial crisis. If nobody's watching the store, bad things happen. The recent Wells Fargo case involving consumer cross-selling—a core strategy deeply ingrained in Wells Fargo's history, culture and incentive systems—shows how easily a good institution and good people can overstep even the most basic trust and fiduciary constraints in dealing with "soft target" consumers.

Indeed, in a highly competitive financial services market, profit often lurks in the shadows. Retail finance is particularly vulnerable to questionable financial practices, given its gaps in information and understanding. So it is surely in the public interest to focus on remedies for market imperfections and professional malfeasance as they appear, and if possible to preempt them. It may not be the "best" and most efficient approach, but "second best" can also leave the world better off. As always, the devil is in the details.

Whether the Trump administration and Congress ultimately choose the "high road" to consumer financial protection remains to be seen.