

The Dramatic Rise of Consumer Protection Law

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The last few decades have seen a dramatic rise in state consumer protection legislation. Beginning in the early 1960s, these laws arose from a perception that market forces, the Federal Trade Commission (“FTC”), and state common law did not protect consumers adequately. State legislatures responded by enacting a diverse collection of statutes, commonly referred to as Consumer Protection Acts (“CPAs”), most of which were originally intended to supplement the FTC’s objectives of protecting consumers from “unfair or deceptive acts or practices.”¹ By 1981, all states had their own version of a CPA.

The federal government has returned to the field with the Dodd-Frank Act,² which regulates nearly every aspect of the financial services industry and consolidates all federal consumer protection duties in a single agency: the Consumer Financial Protection Bureau (CFPB). The statute was the product of a perfect storm: the onset of the financial crisis, the rise

¹ 15 U.S.C. § 45(a)(1) (2006).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301 (2010) [hereinafter Dodd-Frank Act].

of behavioral law and economics, and the broader interpretation of state CPAs – which had already expanded the scope of consumer protection. Combined, these forces have proven potent.

Yet despite the meteoric rise in consumer protection legislation, it is unclear that consumers are better off. On the one hand, consumer protection laws help solve problems such as the informational asymmetries between well-informed manufacturers and poorly-informed consumers. On the other hand, expanded liability can also increase prices beyond what consumers would be willing to pay and deter pro-competitive conduct.

Empirical evidence suggests that consumer protection legislation often fails to account for two factors: (1) the significant costs of regulation, both intended and otherwise, that are passed on to consumers, and (2) the sound and rational reasons why consumers borrow. These omissions inevitably lead to unintended consequences in regulated markets – which may have results as severe as pricing consumers out of the relevant market altogether or reducing incentives to generate pro-consumer information or innovations.

The Rise of Consumer Protection

The first CPAs were passed in the 1960s; in 1962, only eight states had CPAs. Less than twenty years later, they had become fixtures of every state regulatory regime. When first enacted, most CPAs were intended to supplement the perceived gap in consumer protection by allowing for private causes of action that mimicked enforcement actions brought by the FTC.³

³ Nat'l Ass'n of Att'ys Gen. Comm. on the Office of Att'y Gen., Report on the Office of Attorney General 395 (1971).

Since then, state CPAs have generally increased in scope. For example, while suits under the FTC Act require the litigation serve the public interest, many state CPAs have eliminated this public interest requirement. Many define “injury” to a party more loosely and provide liberal standing requirements.⁴ Additionally, CPAs are becoming more favorable and generous to consumer plaintiffs. Such factors have fuelled an increase of 119% in the number of CPA decisions reported in federal district and state appellate courts between 2000 and 2007.⁵ This increase has naturally been especially great in states with CPAs most friendly to consumer litigants.

The rise of behavioral law and economics has also played a significant role in the creation and adoption of recent consumer protection legislation. Behavioral law and economics suggests that consumers often make irrational decisions, and has been thought to argue for restrictions on consumer choice.⁶ Indeed, behaviorist arguments ground legislative proposals as monumental as the CFPB itself, a product of behaviorists such as Oren Bar-Gill and Elizabeth

⁴ Searle Civil Justice Institute, *State Consumer Protection Acts, An Empirical Investigation of Private Litigation* (2009), available at <http://www.law.northwestern.edu/searlecenter/issues/index.cfm?ID=86> [hereinafter *Searle Study*]; Henry N. Butler and Jason S. Johnston, *Reforming State Consumer Protection Liability: An Economic Approach*, 2010 *Colum. Bus. L. Rev.* 1, 9 (2010).

⁵ *Searle Study*, supra note 4, at 20.

⁶ See Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, 157 *U. Pa. L. Rev.* 1 (2008).

Warren.⁷ Behaviorists contend that consumers systematically make choices that are both to their detriment and unrepresentative of their true preferences.⁸ Agencies such as the CFPB might then improve consumer decision making by altering the basic design of consumer credit products, adding disclosure requirements, reducing consumers' choices, or instituting default rules favoring products approved by the given legislative agency.⁹

Legislators have warmed to the behaviorist philosophy – unsurprising, given its purported ability to identify and alleviate significant consumer error. In addition, general behaviorist arguments have the benefit of allowing for a myriad of regulatory responses to perceived irrational decisions. Indeed, much of the appeal of behaviorism would seem to be the permission slip it offers to regulators.

Despite its present popularity, behaviorist theory suffers from serious infirmities that should caution legislators against employing it as a basis for sweeping legislation. Behavioral law and economics presently lacks any theory that can provide the sufficient and necessary conditions to predict any specific bias. In part, this problem stems from a deficit of empirical information establishing the set of circumstances under which irrational decision making is increased. Additionally, behaviorist arguments generally fail to take sufficient account of the

⁷ Id.

⁸ Id.

⁹ David S. Evans and Joshua D. Wright, The Effect of the Consumer Financial Protection Agency Act of 2009, 22 *Loy. Consumer L. Rev.* 277 (2010).

comparative costs and benefits of other legal regimes, leading to a “Nirvana Fallacy.”¹⁰ This fallacy arises in several ways. In one variant, behaviorist advocates assume consistent irrationality from consumers while assuming consistent (and costless) rationality from regulators. In another, behaviorists underestimate – sometimes to zero – the costs of drafting and implementing behaviorist “nudges.”

Problematically, the financial crisis has exacerbated the use of behavioral law and economics by would-be regulators. The intellectual basis of the CFPB wrongly assumes that the exploitation of irrational consumers caused the financial crisis. As such, critics argue that the failure of current consumer protection law was a meaningful cause of the financial crisis, and, further, that a novel federal agency with enhanced powers is required.¹¹ Employing behavioral law and economics specifically, advocates of the CFPB argue that a “supernanny” should be

¹⁰ See Harold Demsetz, Information and Efficiency: Another Viewpoint, 12 J. L. Econ. 1, 1–3 (1969) (“The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing ‘imperfect’ institutional arrangement. This nirvana approach differs considerably from a comparative institution approach in which the relevant choice is between alternative real institutional arrangements.”).

¹¹ 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).

established to prevent consumers from utilizing their flawed evaluations of their ability to repay loans to their own detriment.¹²

However, such proponents fail to offer evidence that consumer irrationality or ignorance was a significant cause of the crisis. While consumers may very well tend to reach incorrect valuations of future values, this tendency was not a substantial cause of the financial crisis. Rather, loan terms which made defaulting attractive and rational to buyers logically established a situation in which defaulting proliferated.

Changes in Consumer Protection Law

Along with the dramatic rise of consumer protection legislation have come significant alterations to both state and federal regulatory regimes.

A. State Law

Today, every state has its own CPA, all of which provide for private causes of action. The original impetus for these regulations derived from three forces present in the 1960s: dissatisfaction with FTC consumer protection enforcement, popular demand for an increase in consumer protection (and business regulation as a whole), and dismay over the perceived

¹² See, e.g., Michael S. Barr, Sendhil Mullainathan and Eldar Shafir, Behaviorally Informed Financial Regulation (New American Foundation, Working Paper, October 2008) (arguing that the CFPB is necessary to “nudge” consumers toward better decision making in lending markets).

inadequacies of common law causes of action. These three forces touch on each of the existing mechanisms of consumer protection: federal regulation, market forces, and state common law.¹³

In the 1960s, the FTC was criticized for various reasons: it had misallocated its already insufficient resources; it suffered from political favoritism and regulatory capture; and it protected producers in the name of consumer protection. Proponents of stronger regulation further argued that market forces could no longer offer consumers adequate protection, as the marketplace had become too impersonal and too favorable to producers to properly rein in producers. Similarly, they claimed that common law causes of action were ousted by this new marketplace dynamic. Most common law actions cost impractically high amounts to efficiently enforce. Others still were doctrinally poor fits for prospective consumer protection. For example, common-law injury requirements precluded prospective injunctions.

State legislatures responded by enacting a diverse collection of CPAs, each intended to supplement public enforcement and to improve consumer outcomes. Most early CPAs authorized state Attorneys General to seek injunctions against specific practices. Some even allowed the Attorney General to seek restitution for injured consumers.¹⁴ Many modern CPA

¹³ See Timothy J. Muris, *The Federal Trade Commission and the Future Development of U.S. Consumer Protection Policy* (George Mason Univ. Sch. of Law, Law & Econ. Working Paper Series No. 04-19, 2004) available at http://ssrn.com/abstract_id=545182 (describing the institutions of consumer protection yet neglecting the role of state consumer protection laws).

¹⁴ See, e.g., 1960 New Jersey Laws, ch. 39, at § 5.

characteristics can be traced back to uniform and model statutes that appeared in the late 1960s.¹⁵ The Uniform Deceptive Trade Practices Act (UDTPA), for example, granted consumers a private right of action and allowed injunctive relief absent proof of actual damages and demonstrated intent to deceive.¹⁶

Another important model statute that appeared at this time was the Model Unfair Trade Practices and Consumer Protection Law (UTPCPL). The FTC developed the UTPCPL as a comprehensive and appealing collection of prior elements of consumer protection legislation. The 1970 version of the UTPCPL provided a choice of three forms of unlawful practices.¹⁷ First, unlawful practices could be defined using essentially the same language as Section 5 of the FTC Act.¹⁸ Second, unlawful conduct could be defined as “false, misleading, or deceptive acts or practices in the conduct of any trade or commerce,” though this second option did not include a generally “unfair practices” category.¹⁹ Third, a “laundry list” approach prohibited twelve

¹⁵ See Nat’l Ass’n of Att’y Gen. Comm. on the Office of Att’y Gen., *supra* note 3, at 400.

¹⁶ Comm’rs on Unif. State Laws, Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings of the Annual Conference Meeting in its Seventy-Third Year 253, 262 (1964).

¹⁷ 29 Council of State Gov’ts, 1970 Suggested State Legislation 142 (1969).

¹⁸ Unfair Trade Practices and Consumer Protection Law (Council of State Gov’ts 1970).

¹⁹ 1 Mary Dee Pridgen and Richard M. Alderman, *Consumer Protection and the Law*, § 2:10 (2009).

competition-focused activities and provided a thirteenth provision addressing consumers.²⁰ The UTCPL deliberately attempted to maintain its similarities to the relevant FTC standards, noting that “due consideration and great weight” should be given to the FTC’s own interpretations.²¹ Currently, twenty-eight states reference the FTC in their CPAs.²²

Recent amendments and expansive judicial interpretations have broadened consumer rights under most CPAs. Such amendments have generally increased consumer incentives to sue, for example by allowing for class actions and private claims. Other amendments repeal the “public interest” requirement to sue under the CPA. Some CPAs have truncated rigorous common-law burdens of proof to tilt adjudications towards consumers.²³ Proponents of these amendments, hearkening back to the arguments of the 1960s, contend that consumers must be willing to file suit for CPAs to have any deterrent effect. However, critics have noted that such a

²⁰ See 29 Council of State Gov’ts, *supra* note 17, at 142, 146-47; see also 1 Pridgen and Alderman, *supra* note 19, at § 210.

²¹ 29 Council of State Gov’ts, *supra* note 17, at 147.

²² 1 Pridgen and Alderman, *supra* note 19, at § 210, app. at 3B.

²³ David A. Rice, Exemplary Damages in Private Consumer Actions, 55 Iowa L. Rev. 307, 307 (1969).

structure raises the potential for harassment of legitimate business conduct²⁴ and that vague consumer fraud statutes create an environment ripe for abuse.²⁵

Nonetheless, the trajectory of state consumer protection law is clear. Economic theory predicts that the level of litigation under a CPA should be influenced by the expected value of a claim to a generic, potential CPA plaintiff. From the time the CPAs were originally adopted within a state, there has been significant variation in the content of CPAs between states, but the direction is clear: state consumer protection law has changed in favor of plaintiffs.²⁶

B. Federal Consumer Protection Law

Federal consumer protection has historically been more conservative than state CPAs. Unlike state CPAs, the FTC does not provide a private right of action. Additionally, the FTC requires reasonable reliance as a component of its definitions of unfair and deceptive practices.

²⁴ William A. Lovett, Louisiana Civil Code of 1808: State Deceptive Trade Practice Legislation, 46 Tul. L. Rev. 724, 744 (1972).

²⁵ See, e.g., David A. Rice, Exemplary Damages in Private Consumer Actions, 55 Iowa L. Rev. 307, 340 (1969).

²⁶ See Searle Study, *supra* note 4. The Searle Study generated an index (the “Expected Value Index” or EVI) to capture the overall “plaintiff friendliness of the state CPA. For each 2008 statute, 27 variables were coded as either “benefits” or “restrictions.” *Id.* The Study found that that the EVI is positively correlated with the log of reported CPA decisions. *Id.*

The FTC further employs a cost-benefit standard in determining what constitutes legally actionable “unfair” practices under Section 3 of the FTC Act.²⁷ Given the comparative constraints the FTC retains, it has periodically come under fire for the same reasons that underlie the establishment of state CPAs.

The Dodd-Frank Act represents a radical pro-plaintiff shift in federal consumer protection legislation. The CFPB is slated to assume the consumer protection responsibilities of all other federal regulatory agencies²⁸ in the market for consumer financial products and services. Two broad aspects of the Dodd-Frank Act will drastically affect the consumer credit market.

First, the Dodd-Frank Act dramatically alters current consumer financial protection laws.²⁹ For example, the Act limits the federal preemption of consumer protection regulation of

²⁷ See Federal Trade Commission Act Amendments of 2006, Pub. L. 109-455, § 3, 120 Stat. 3372 (codified at 15 U.S.C. § 45(n)) (defining an unfair act as one that “causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or competition.”); J. Howard Beales III, *The FTC’s Use of Unfairness Authority, Its Rise, Fall, and Resurrection* (May 30, 2003), <http://www.ftc.gov/speeches/beales/unfair0603.shtm>.

²⁸ These include the Federal Reserve Board of Governors, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, National Credit Union Administration, and the Federal Trade Commission. See Dodd-Frank Act, *supra* note 2, at § 1061.

²⁹ The following examples listed here arise either from provisions of the Dodd-Frank Act as passed or from proposals once contained by the CFPB Act. As the Dodd-Frank Act grants the

nationally chartered financial institutions, by allowing states and municipalities to enact more exacting regulations than those promulgated by the CFPB.³⁰ Essentially, the Act simultaneously creates a regulation “floor” while encouraging the adoption of more stringent standards.³¹ By doing so, the Act exposes financial institutions to substantial increases in compliance costs.

Additionally, the Act alters consumer protection laws as applied to financial products. The CFPB is explicitly authorized to take 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.”³² Unfortunately, the CFPB is further authorized to define which practices are “unfair” or “deceptive” in a manner that may not comport with the longstanding jurisprudence guided by the FTC.³³

The Dodd-Frank Act also creates in the CFPB an entirely new agency with the authority to become directly and significantly involved in determining crucial aspects of the terms and

CFPB virtually plenary regulatory authority to promulgate rules in the public interest, virtually all of these requirements – even those not encapsulated by the final bill – could easily be implemented by procedures authorized under the Administrative Procedure Act and Dodd-Frank.

³⁰ Dodd-Frank Act, *supra* note 2, at §§ 1041(a)(1), (b).

³¹ New Foundation, *supra* note 11, at 50-51.

³² Dodd-Frank Act, *supra* note 2, at § 1031(a).

³³ *Id.* at § 1031(c).

conditions under which covered businesses are permitted to offer credit to consumers.³⁴ Importantly, the CFPB may consider mandating that lenders offer consumers “plain vanilla” products of the CFPB’s own design. This power was explicitly included in the original CFPB legislation,³⁵ and may still be achieved pursuant to the wide grant of power in the Dodd-Frank Act. In fact, the CFPB could even require that consumers explicitly reject the “plain vanilla” option before the lender is permitted to offer its own option. Even if consumers reject the “plain vanilla” product, the CFPB may require firms to provide warnings to consumers of the increased risks of alternative, non-CFPB approved products. These and similar changes would raise barriers to entry in consumer financial product markets, reduce incentives to innovate, and decrease competition.

An Empirical Perspective on the New Era of Consumer Protection

A. Theoretical Discussion

The behavioral incentives created by state CPAs generate, at a minimum, an ambiguous theoretical prediction concerning their net consumer welfare effects, and serious concerns that

³⁴ Id. at § 1031.

³⁵ United States Department of the Treasury, Consumer Financial Protection Agency Act of 2009 § 1036(b) (2009), available at <http://www.financialstability.gov/docs/CFPA-Act.pdf> (proposing 2009 Consumer Financial Protection Agency legislation for passage by Congress).

state CPAs could make consumers worse off in some contexts.³⁶ CPAs generally reach what might be classified as two broad categories of conduct: selling practices and marketing communications (including advertising). In theory, CPA liability which forces sellers to internalize the social costs associated with deceptive selling practices or marketing practices could increase efficiency and consumer welfare. On the other hand, CPA liability can lead to serious social harms as well that must be offset against any benefits.

These harms can also be usefully classified into two categories. First, CPA liability in the market for consumer goods and services amounts to what Butler and Johnston describe as “what is effectively a tax on every good or service sold to consumers.”³⁷ Like other forms of excise taxes, CPA liability can raise the marginal costs of production for the firm, and result in reduced output and higher product prices. The second category of harm applies most directly to marketing communications. Because such communications can disseminate valuable information to consumers, liability that chills informative advertising can reduce consumer welfare. There is some danger that state CPAs, especially those that are interpreted in a broad fashion, may deter firms from making partial disclosures of information that are likely to trigger liability, but provide valuable information to consumers.

While these basic tradeoffs involving CPAs are well known and recognized even by their proponents,³⁸ there is no hard evidence on the relative magnitudes of any of the relevant effects

³⁶ Butler and Johnston, *supra* note 4, at 44-53.

³⁷ *Id.* at 44.

³⁸ See, e.g., Jeff Sovern, *Toward a New Model of Consumer Protection Statutes: The Problem of Increased Transaction Costs*, 47 *Wm. & Mary L. Rev.* 1365, 1705-09 (2006) (recognizing that

on consumers. While theories of consumer protection are in conflict, the proper question to ask is clear: whether the rise of consumer protection legislation will optimally prevent consumer abuse. Proponents of the rise in consumer protection legislation proffer numerous arguments as to why such increases are beneficial. Both “gaps” in FTC enforcement and behaviorally-documented consumer biases are frequently presented as justifying the additions to the consumer protection landscape. Indeed, state CPAs encourage individuals to bring small but meritorious suits they would not otherwise have incentive to bring, due to restrictions on remedies; and consumers are not subject to the same political pressures as the FTC. Additionally, consumer protection laws can be important in correcting problems of informational asymmetries and in solving market failures. However, such arguments, without more, are incomplete.

As always, the potential benefits of additional state consumer protection regulations must be evaluated while accounting for existing and alternative frameworks, as well as any costs in changing the relevant legal regime. As Butler and Johnston note, part of this inquiry requires asking whether consumer protection legislation optimally supplements other enforcement mechanisms (e.g., market forces, federal regulation, and state common law).³⁹ In determining what level of protection is optimal, costs of overprotection and expanded liability are important considerations, as they might increase prices beyond what consumers would want to pay, and deter pro-competitive behavior.

state CPAs can increase transaction costs and arguing for regulation that would prevent firms from passing these costs on to consumers).

³⁹ Butler and Johnston, *supra* note 4, at 4-5.

B. Empirical Evidence on State CPAs

The dramatic growth in state CPAs' scope warrants further scrutiny concerning the differences between consumer protection under state and federal law. One experiment analyzing the decisions of a "Shadow Federal Trade Commission" provides empirical evidence of how CPAs operate in relation to the FTC standard.⁴⁰ In this study, an expert panel evaluating the facts of litigated state CPA claims found that state CPAs appear to condemn conduct that would not be illegal under the FTC standard.⁴¹ Indeed, the Searle Study found that only 22% of CPA claims would constitute illegal conduct under the FTC standards.⁴² Significantly fewer (12%) would lead to FTC enforcement.⁴³ While this particular finding might be consistent with the proposition that CPAs are intended to supplement FTC enforcement, the Searle Study found that almost 40% of CPA claims in which the consumer plaintiff prevailed at trial would not amount to illegal conduct under the relevant FTC standard.⁴⁴

By permitting such different, broader claims, CPAs raise serious questions of whether their existence actually benefits consumers. Many CPAs employ vague definitions of illegal

⁴⁰ Searle Study, *supra* note 4.

⁴¹ *Id.* at 49-50.

⁴² *Id.* at 39.

⁴³ *Id.*

⁴⁴ *Id.* at 49.

conduct, creating costly uncertainty. Businesses must expend resources attempting to predict how vague CPA standards will be enforced; judges must expend further resources defining illegal conduct and sorting between meritorious and frivolous claims. These added costs are directly and indirectly filtered back to consumers in the form of higher prices. Measurement of these direct impacts on consumer welfare is an important area for future research.

Consumer litigants appear rationally responsive to CPA incentives: statutory language providing more generous remedies and less stringent requirements encourages more lawsuits.⁴⁵ Vague CPA language will further increase litigation in these states. Such a result is problematic when the litigation is costly and of such questionable value as here.

C. Empirical Evidence on the CFPB's Predicted Effects

The CFPB has the potential to raise the cost of providing credit significantly. By dramatically altering the legal regime under which financial institutions now operate, the CFPB will increase exponentially both uncertainty and costs of compliance for covered businesses. In turn, these cost increases will affect consumers both by reducing overall consumer access to (and use of) credit and by preventing some consumers from obtaining credit products at all.

The CFPB will force lenders to bear significant legal costs for lawsuits arising from the vague language of its enabling legislation and from state variance arising from Dodd-Frank's "floor" regulations. The CFPB not only departs from the traditional FTC definitions of "unfair" and "deceptive," but grants powers sufficient to establish entirely new causes of action –

⁴⁵ Id.

established by ambiguous terms that will necessarily require serious court interpretation, with no clear indication currently offered for what definitions approximate the optimal result. Such costs will likely be passed on to consumer, at least in part.⁴⁶

The legal uncertainty created by the CFPB will impose further costs on the credit market. While waiting for courts to coherently and precisely define the Act's relevant terms and the CFPB's regulations, lenders will proceed with excessive caution. Added paperwork, new mandatory review processes, and a potential "plain vanilla" requirement also add costs.

Most importantly, the Dodd-Frank Act's consumer protection provisions and the rules and regulations promulgated and enforced by the CFPB may price certain consumers entirely out of the lending market. This exclusion will likely result in the unluckiest of consumers becoming liquidity constrained from the loss of sound and rational opportunities to borrow. First, lenders will stop offering some beneficial products that will become unprofitable under the new regime. Second, given the behaviorist rationale underlying its creation, the CFPB will likely assert its authority to prevent consumers from obtaining access to products that consumers want but that the CFPB subjectively believes are in some way bad for them. This second reason is particularly

⁴⁶ Other industries have had to pass on to consumers costs imposed on them by exposure to state litigation. See, e.g., Professor Michael J. Saks' letter to Sen. Ernest Hollings, S. 687. The Product Liability Fairness Act: Hearing before the Subcommittee on Consumer of the Committee on Commerce, Science, and Transportation, United State Senate, One Hundred Third Congress, First Session, September 23, 1993, 126.

troubling given that consumers are necessarily in a better position than regulators to determine which credit options are most beneficial to their particular needs.⁴⁷

Evans and Wright estimate that the Dodd-Frank Act will increase interest rates consumers pay by 160 basis points (or by 1.6%) and reduce consumer borrowing by 2.1%.⁴⁸ Naturally, the Act will impose a significant cost shock to lenders. As the Act will result in significant variation in state-by-state regulation, transactions costs for lenders will increase. Of course, the greater the variation between states, the greater these costs will be.

In addition to paying more for credit, consumers will use less credit – with a resulting negative impact on consumer spending. With a 1.3 estimate for long-run debt elasticity in consumer credit markets,⁴⁹ a 160 basis point increase would result in a 2.1 percent reduction in

⁴⁷ Creditors face serious problems of information asymmetry in deciding to whom to lend. Consumers are aware of specific factors affecting their likelihood of default that creditors cannot hope to know, including their individual incentive to pay back a loan given possibly generous debt relief laws. For a comprehensive discussion of the risks and benefits of consumer borrowing, see Evans and Wright, *supra* note 9.

⁴⁸ Evans and Wright, *supra* note 9.

⁴⁹ Financial economists have used changes in nominal credit card interest rates to arrive at this estimate. David Gross and Nicholas Souleles, *Consumer Response to Changes in Credit Supply: Evidence from Credit Card Data* (Wharton Bus. Sch., Working Paper, Feb. 4, 2000), available at <http://knowledge.wharton.upenn.edu/papers/1161.pdf>. These estimates are based on credit cards and could be different for other debt products.

the amount of long-term debt or credit borrowing. This estimate serves as a likely lower bound, in part because of the likelihood that the CFPB will ban certain lending products that represent the only credit options for some consumers. Such a reduction in credit availability will likely generate significant consumer losses, as evidenced by economic literature suggesting that harmful effects of such reductions are felt both by the consumers in distress personally and by the communities that are left with diminished capacity to rebound from community shocks.⁵⁰

D. Other Evidence

Additional evidence gleaned from other lending regulations suggests that paternalistic consumer protection legislation harms consumers as a group. These regulations decrease the availability of credit and exclude some consumers from the credit market altogether.

Usury regulation has long been a target of behaviorists and their forerunners. Supporters of additional regulation claim that excessive interest rates necessarily exploit irrational, misinformed borrowers. Behaviorists typically argue that usury works a willing, if unjust, redistribution of wealth from buyers in need to lenders with liquid capital.⁵¹ Accordingly, they

⁵⁰ See Adair Morse, *Payday Lenders: Heroes or Villains?* (Booth Sch. of Bus., Working Paper, Jan. 2009) (finding that restrictions on financial products can result in 1.2 more foreclosures and 2.67 more larcenies per 1,000 homes).

⁵¹ See, e.g., Brian M. McCall, *Learning from Our History: Evaluating the Modern Housing Finance Market in Light of Ancient Principles of Justice*, 60 S.C. L. Rev. 707, 713 (2009), available at <http://ssrn.com/abstract=1462280>.

find that legal interest rates should be capped at “reasonable” levels. Such arguments suffer from a shortsighted and narrow perspective.

Although usury rates may be high, they are necessarily so, and benefit consumers nonetheless. Usury represents far more than a mere wealth transfer. Consumers in need are in need for a reason; this necessity means they pose a significant risk of default to lenders. Lenders in turn must be compensated to make these high-risk loans at all.⁵² This compensation is the driving force behind both high-interest loans and permissive usury laws. Accordingly, capping legal interest rates will not eliminate the need for such compensation – it will only eliminate the lender’s presence in the market for consumer borrowing.

Economic literature suggests that paternalistic restrictions that destroy consumers’ ability to access nontraditional sources of lending, such as payday and auto title loans, have two significant and unintended consequences: term re-pricing and product substitution.⁵³ Term re-pricing, where lenders alter other terms of the agreement, harms consumers by increasing the costs of other lending terms, such as by requiring higher down payments. Product substitution, where some consumers are denied access to traditional lenders, represents the reality that consumers will turn to less favorable credit options (such as pawn shops or loan sharks) or find

⁵² See, e.g., Wendy Edelberg, Risk Based-Pricing of Interest Rates in Household Lending Markets 2-5 (FEDS Working Paper No. 2003-62, Dec. 2003), available at <http://ssrn.com/abstract=484522> (noting the increase in risk-based pricing of interest rates in consumer lending markets).

⁵³ Todd J. Zywicki, Consumer Use and Government Regulation of Title Pledge Lending, 22 *Loy. Consumer L. Rev.* 425, 428-33 (2010).

themselves priced out of the credit market altogether. Proponents of paternalistic regulations argue that such exclusion is warranted, as borrowers would only be made worse off by the exploitative lending terms inherent in nontraditional options. Such proponents further argue that because consumers utilize these credit options for reasons that are not obvious, they are unable to estimate accurately the actual costs of such loans and cannot compare the costs of these loans to the costs of traditional credit options.⁵⁴ The theoretical and empirical literature, however, suggests that consumers are well aware of the costs of payday lending.⁵⁵ Moreover, both evidence and economic theory suggest that consumers benefit from nontraditional lending options. For example, auto title loans seem to be most beneficial for three types of rational consumers: moderate income borrowers priced out of traditional credit markets by damaged credit history; lower income, unbanked borrowers who utilize these loans to meet unexpected expenses; and small businesses.⁵⁶

Similar behavioral law and economics arguments are made in the context the credit card market. The “seduction by plastic” argument presumes that consumers are irrationally induced

⁵⁴ Nathalie Martin, 1,000% Interest – Good While Supplies Last: A Study of Payday Loan Practices and Solutions 52 Ariz. L. Rev. 563 (2010), 35 (Univ. N.M. Sch. of Law Research Paper No. 2010-05), available at <http://ssrn.com/abstract=1664616>.

⁵⁵ Gregory Elliehausen, An Analysis of Consumers’ Use of Payday Loans, 36-37 (Div. of Research & Statistics, Bd of Governors of the Fed. Reserve Sys. & Fin. Servs. Research Program, The George Washington Univ. Sch. of Bus.).

⁵⁶ Zywicki, *supra* note 53, at 426.

into credit arrangements through short-term features such as introductory rates. Consumers then accumulate more debt than originally anticipated, and are eventually subject to higher interest charges than subjectively assumed.⁵⁷ This irrationality leads to welfare losses, or so the argument proceeds. Yet in this area as well, paternalistic arguments fail to demonstrate a need for stringent consumer protection regulations.⁵⁸ For example, these models predict clear welfare losses, but fail to explain how this might happen when lenders compete by offering greater short term benefits to consumers until all supra-competitive profits are dissipated.⁵⁹ This competition is consistent with both rational consumers and a robust market for credit products. As such, paternalistic interventions would likely inhibit competition between lenders, and it is unclear that any consumer benefit from this intervention would outweigh these competitive losses.

Conclusion

The dramatic rise of consumer protection legislation has been thought to be justified by consumer ignorance or judgment biases. However, such legislation appears to have underestimated its social costs. These costs arise from increases in compliance costs and from

⁵⁷ Oren Bar-Gill, *Seduction by Plastic*, 98 *Nw. U. L. Rev.* 1373, 1399-1400 (2004).

⁵⁸ See Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective*, 2 *N.Y.U. J. L. Liberty* 470-511 (2007).

⁵⁹ *Id.*

failures to acknowledge the benefits inherent in existing consumer protection mechanisms, such as market forces, state common-law actions, and the FTC.

These cost increases will have serious impacts on consumers as a class. Consumer protection legislation can indeed play an important role in correcting market failures and eliminating information asymmetries. However, the recent additions to (and renovations of) the consumer protection landscape threaten to create significant deadweight losses by reducing consumer choice, deterring efficient firm behavior, expanding liability for lenders, and encouraging rent-seeking behavior. Accordingly, there is significant reason to be skeptical of claims that the dramatic rise of consumer protection law in the United States over the past forty years, and especially recently, has generated net benefits for consumers.

State CPAs in particular raise federalism challenges familiar to many areas of concurrent federal regulation. While it appears that State CPAs impose serious costs on the civil justice system and consumers, jurisdictional competition can play an important role in disciplining consumer protection institutions. It is, at this point, too early in the evolution of State CPAs to surrender the potential benefits from such competition and conclude that consumer protection should be left to federal regulators. Indeed, any discussion concerning the relative merits of federal and state consumer protection regulation must be informed by the troubled history of the FTC in this area as well as the expansive authority recently granted to the CFPB.