

WRITTEN TESTIMONY OF PROFESSOR ROBERT M. LAWLESS
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**“Consumer Protection and Middle Class Wealth Building
in an Age of Growing Household Debt”
Hearing of the United States Senate Subcommittee
on Financial Institutions and Consumer Protection**

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Congress created the Consumer Financial Protection Bureau (CFPB) to put an end to lending practices that rely on consumer confusion to create profits for the lenders. Although the CFPB has now come into existence, partisan politics have hampered the CFPB’s ability to fully vindicate its statutory mandate. The Senate has yet to act on the confirmation of a permanent director, and some members of Congress have vowed to scale back the agency’s powers. Thank you for inviting me here today. In my testimony, I will describe the problems that led Congress to create the CFPB in the first place and how these problems continue to plague American consumers.

I am a professor of law and co-director of the Illinois Program on Law, Behavior & Social Science at the University of Illinois College of Law. In my courses and research, I study the problems that lead both consumers and businesses into financial distress and how we as a society react to financial distress. Along with seven other scholars, including co-panelist Professor Katherine Porter, I regularly contribute to *Credit Slips* (<http://www.creditslips.org>), a blog that discusses issues related to credit, finance, and bankruptcy. My testimony today draws on what I have learned as a scholar and teacher of lending and bankruptcy. The views I am expressing are my own and not necessarily the views of my university or any other organization with which I am affiliated.

A Middle-of-the-Road Agency

I am here today as someone who was skeptical about the creation of a consumer financial agency.¹ My skepticism stemmed not from the oft-repeated concerns over an agency that has too much authority. Rather, my concern was that a consumer financial agency did not go far enough. Professor Warren framed her proposal for a consumer financial agency largely in terms of informational problems between consumers and lenders.² Under this vision, plain English disclosures would ameliorate many of the most abusive lending practices. In Professor Warren's words, "the basic premise of a market is full information." The agency would stand in the middle between consumers and lenders to ensure consumers were acting with full information.

Although providing consumers with more information is a laudable goal, many consumer lending transactions simply transfer wealth away from persons living at the economic margins of society and put this wealth in the pockets of large financial institutions. If we decide as a society that these wealth transfers are intolerable, the answer is not to surround these transactions with more information but to ban these transactions altogether. Vigorous and effective usury caps would put an end to predatory lending at rates approaching a 300% or 400% APR. If, for example, consumers systematically make mistakes to choose credit cards with low teaser rates but higher long-term costs, then the answer is to limit the use of teaser rates.

At the time of Dodd-Frank, people of good judgment and good faith differed on what Congress should do to prevent a repeat of the consumer lending abuses that played a role in creating the financial crisis. In the heated rhetoric that often surrounds any discussion of the CFPB, it has been forgotten that the agency in many ways was a compromise solution between those who wanted to go further and those who thought no little or new regulation was necessary.

My other reason for skepticism was the problem of regulatory capture. In legal and political science scholarship, "regulatory capture" describes a situation where an administrative

¹ *The Limits of Contract as Product*, 157 U. Pa. L. Rev. PENnumbra 160 (2009) (available at <http://www.pennumbra.com/responses/02-2009/Lawless.pdf>).

² Oren Bar-Gill & Elizabeth Warren, "Making Credit Safer," 157 U. Pa. L. Rev. 1 (2008); Elizabeth Warren, "Unsafe at Any Rate," *Democracy: A Journal of Ideas*, Summer 2007, at p. 8

agency becomes beholden to the interests it regulates. The agency begins to act on behalf of those interests instead of the citizenry. Regulatory capture can happen for institutional reasons such as the fact that the regulated companies often have the greatest incentive to monitor and lobby the administrative agency. Cultural forces also play a role as agencies often draw their employees from the same labor pool as do the companies they regulate or as agency employees come to know their counterparts in the regulated industry.

In financial regulation, regulatory capture has been particularly acute. The Office of the Comptroller of the Currency (OCC) draws its budgets from the fees of the banks it regulates. Many observers have noted the OCC often seems to act in ways that attract regulatory business and hence higher fees and bigger budgets.³ Commentators made similar observations about the Office of Thrift Supervision (OTS), an agency eliminated by Dodd-Frank.⁴ In their article proposing a consumer financial agency, Professors Bar-Gill and Warren described a broad failure across a number of agencies to regulate on the behalf of consumers: the Federal Reserve, the OCC, the OTS, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Trade Commission.⁵

To minimize the risk of regulatory capture in an area that had proven so susceptible to it, Congress tried to insulate the CFPB from political influences. As the subcommittee is undoubtedly aware, there have been innumerable proposals to tear down the structures that protect the CFPB from interest-group politics. Efforts to replace the one-person director of the CFPB with a commission or place the CFPB's budget under the immediate control of Congress are steps in the wrong direction. Indeed, the very existence of these efforts, largely centered in the financial services industry, demonstrates the need for vigilance in keeping the CFPB a truly

³ Adam Levitin, "Why the OCC Can't Be Relied on for Consumer Protection," *Credit Slips* (Aug. 21, 2008) (<http://www.creditslips.org/creditslips/2008/08/why-the-occ-can.html>); Stephanie Mencimer, "No Account: The Nefarious Bureaucrat Who's Helping Banks Rip You Off," *The New Republic*, Aug. 27, 2007, at 14 (<http://www.tnr.com/article/no-account>); Alan White, "OCC Findings: Illegal Foreclosures, Critical Deficiencies," *Credit Slips* (Feb. 17, 2011) (<http://www.creditslips.org/creditslips/2011/02/occ-finds-illegal-foreclosures-critical-deficiencies.html>).

⁴ U.S. Senate Permanent Subcommittee on Investigations, Staff Report, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," pp. 161-242 (Apr. 13, 2011) (http://hsgac.senate.gov/public/files/Financial_Crisis/FinancialCrisisReport.pdf); Robert Cyran, "The Downfall of a Regulator," *N.Y. Times*, Apr. 8, 2009 at B2 (<http://www.nytimes.com/2009/04/09/business/09views.html>).

⁵ Oren Bar-Gill & Elizabeth Warren, "Making Credit Safer," 157 U. Pa. L. Rev. 1, 86-97 (2008).

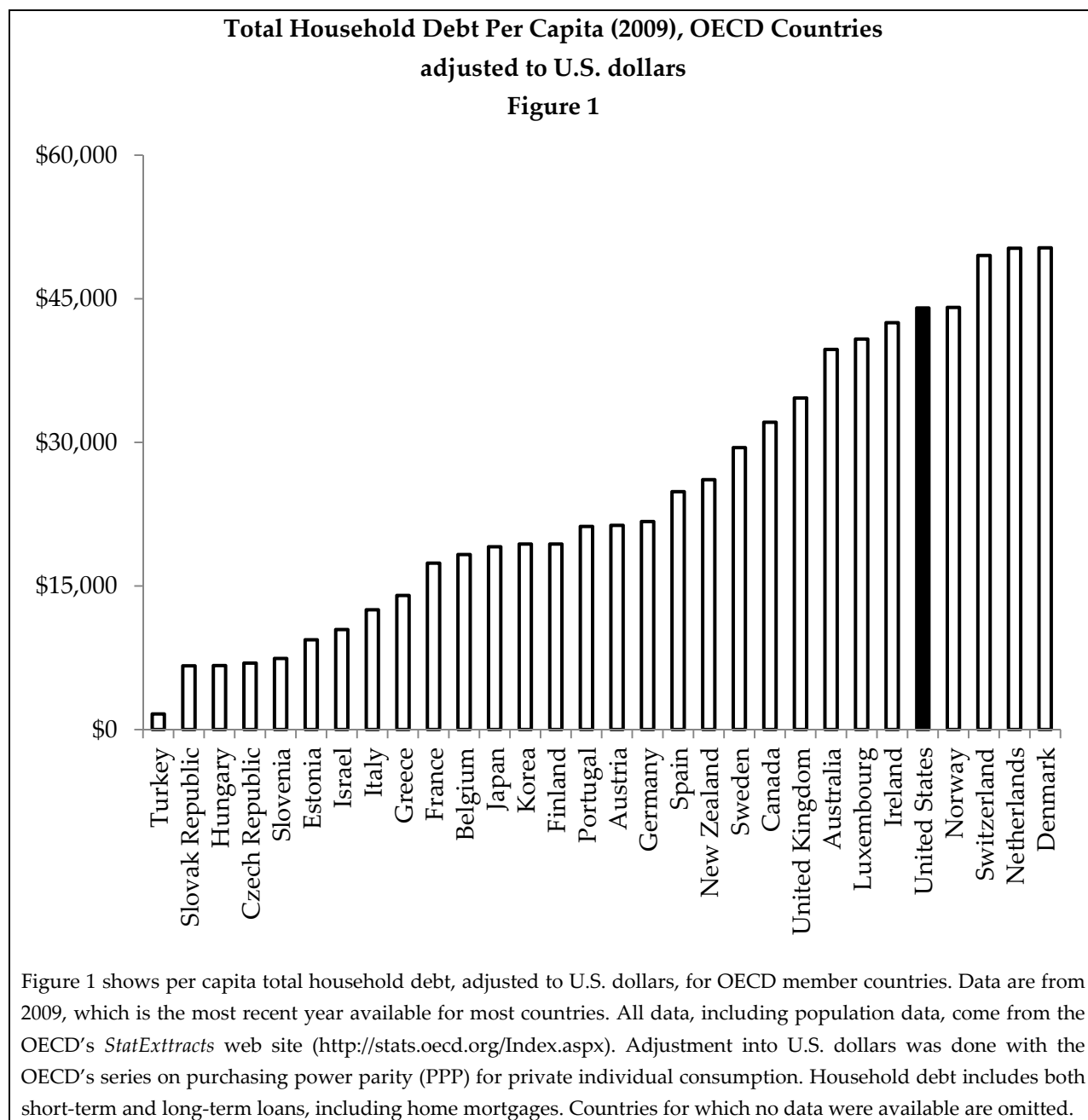
independent agency. In an era of permanently indebted private households and complex financial instruments that provide opportunities for abuse at the expense of everyday Americans, we need an effective CFPB that will not be the hand maiden of the industries it needs to regulate.

An Indebted Society

Congress did not design the CFPB as an “anti-debt” agency. Used properly, borrowing can be an effective financial strategy for many consumers. Many Americans pay for their homes, their cars, and their educations through well-considered decisions to borrow money. Individually, many of these borrowing decisions undoubtedly made sense. In the aggregate, however, these individual decisions have made America an indebted society with remarkably high levels of household debt. The rush by financial institutions to supply this debt played a role, if not the major role, in creating our current financial crisis. An effective CFPB not only can minimize the systemic risk that comes from high levels of household debt but also act to minimize the harm that can befall individual borrowers when they enter into borrowing decisions they do not understand or cannot possibly afford.

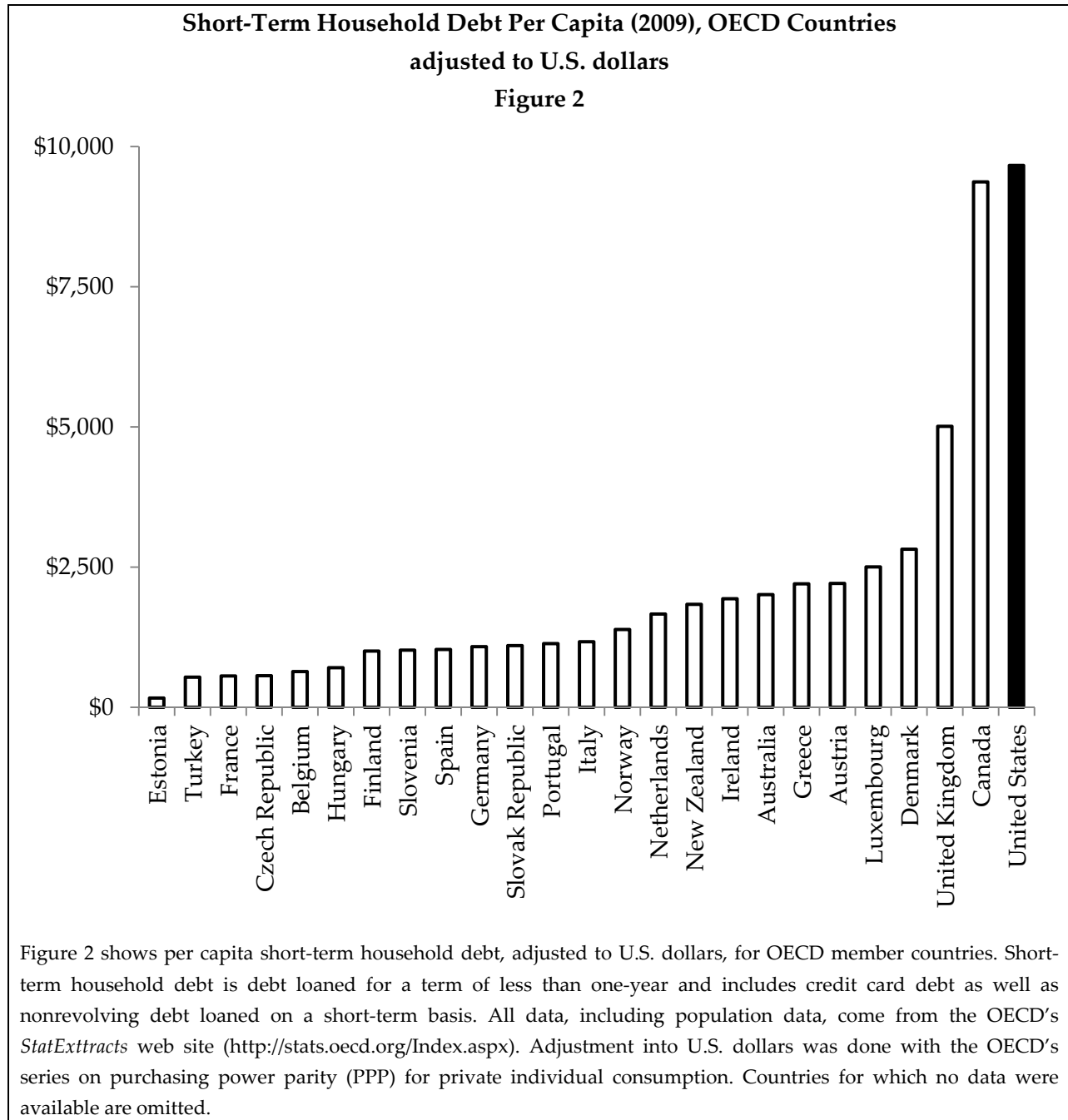
Without question, the financial crisis has reduced the amount of outstanding consumer debt. According to the Federal Reserve, consumer debt has shrunk by 4.2% since the beginning of 2008 to July 2011 (the most recent data available).⁶ This small reduction in consumer debt is a drop in the bucket compared to the massive run-up during the past several generations. Even after adjusting for inflation and population growth, consumer debt has risen 46% in the past twenty-five years and 106% in the past fifty years. When mortgages are considered, private household debt has increased 220% in the past twenty-five years and a staggering 374% in the past fifty years. Many Americans now spend most of the adult lives owing debts to some financial institution.

⁶ Federal Reserve Statistical Release G.19 (July 2011). The term “consumer debt” does not include mortgages.



Compared to other countries, Americans are a deeply indebted people. According to the most recent data from the Organization for Economic Co-operation and Development (OECD), Americans had total household debt of \$44,041 for every man, woman, and child in the country, the fifth highest among all OECD countries as illustrated by Figure 1. Adjusting for population allows for comparison across borders. Using per capita figures, however, understates the true

debt burden because not every man, woman, or (especially) child has outstanding debt. For the average person carrying debt, the burden is much higher than \$44,041.



When considering just short-term household debt, the United States leads all OECD countries with \$9,663 owed per capita. The OECD defines short-term debt as any debt loaned

for less than one year. Long-term debt is debt loaned for periods of greater than one year with the biggest components of long-term debt being home mortgages and automobile loans. Short-term debt is typified by credit card debt and payday lending. Thus, consumers are much more likely to be using short-term debt for immediate consumption. It is exactly these types of borrowing decisions where consumers are more likely to act quickly, perhaps under some pressure and without careful shopping among different lenders. It is exactly these types of borrowing decision where lenders can exploit consumer confusion and lack of information. It is exactly these types of borrowing decision where the CFPB can be most effective. And, it is exactly these types of borrowing decision in which Americans lead the world.

Household Debt, Bankruptcy, and the CFPB's Role in Research

In its invitation, the subcommittee asked for my views on “the role of consumer financial products in contributing to excessive household indebtedness and, in the extreme, bankruptcy.” Part of that question is easy to answer, and part of that question is much more difficult to answer. After explaining the easier part of the answer, I will turn to how the CFPB would be incredibly helpful in answering the more difficult part of the question.

The easier part of the answer is that excessive household indebtedness clearly has a link to bankruptcy filings.⁷ In the short run, the link is counterintuitive. As consumer debt increases, bankruptcy filings generally decline in the short-term. When consumer debt is more readily available, households can stave off the day of reckoning by borrowing to pay for rent, medical expenses, groceries, and the other necessities of daily life. A tightening of consumer debt generally has the opposite effect, driving more people into bankruptcy in the short term. When its effects are measured over a long run, however, consumer debt does lead to increased bankruptcy rates. Because of its relationship to consumer debt, the bankruptcy filing rate can rise even during economic boom times such as the 1990s when earlier increases in debt created

⁷ This discussion is based on my findings in Robert M. Lawless, *The Paradox of Consumer Credit*, 2007 U. Ill. L. Rev. 347. Further discussion appears at Bob Lawless, “One More Time with Feeling,” *Credit Slips* (Aug. 22, 2011) (<http://www.creditslips.org/creditslips/2011/08/one-more-time-with-feeling.html>) and Bob Lawless, “Debt Causes Bankruptcy (But Sometimes in Counter-Intuitive Ways),” *Credit Slips* (Jan. 7, 2011) (<http://www.creditslips.org/creditslips/2011/01/debt-causes-bankruptcy-but-sometimes-in-counter-intuitive-ways.html>).

long-term conditions conducive to bankruptcy filings that then spiked when credit markets became more difficult for consumers to access. Another example is this year, where bankruptcy filings will fall about 10% even amidst a dire economy. The dearth of new consumer debt in the immediate wake of the financial crisis in 2007 and 2008 created a situation where there would be less long-term need for bankruptcy. As consumers have found it slightly easier to borrow this year, the conditions have been created for a decline in this year's bankruptcy filing rate. Thus, contrary to popular wisdom, it is consumer indebtedness, not the nation's overall economy that plays the major role in driving the nation's bankruptcy filing rate.

The more difficult part of the committee's question is the role particular consumer financial products play in creating excessive household indebtedness. Once a consumer gets to bankruptcy court, the fact of the bankruptcy filing and the consumer's circumstances become a matter of public record. Researchers can use this information to understand the relationship between indebtedness and bankruptcy, as we have done, for example, in documenting how Americans are arriving in bankruptcy much further in debt than they did thirty years ago.⁸ As to how people become overindebted in the first place, we have a much poorer understanding. For example, is overindebtedness often due to exogenous shocks like illness or job loss, or are poor purchasing decisions and overconsumption the primary driver? To what extent does culture or other attitudes drive overindebtedness? Are particular consumer financial products more likely to lead to overindebtedness? Are some consumer financial products inherently abusive in that they cost far more than any conceivable benefit they could be giving the borrower? The data that would provide some insight into these questions generally is private and beyond the ability of independent researchers to investigate.

Often lost in the debates over the CFPB is the research function Congress directed it to have. Following the statutory directive given by its enabling legislation, the CFPB now has a research unit that investigates the following issues:

⁸ Robert M. Lawless, Angela Littwin, Katherine Porter, John Pottow, Deborah Thorne, and Elizabeth Warren, "Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors," 82 Am. Bankr. L.J. 349 (2008).

- (A) developments in markets for consumer financial products or services, including market areas of alternative consumer financial products or services with high growth rates and areas of risk to consumers;
- (B) access to fair and affordable credit for traditionally underserved communities;
- (C) consumer awareness, understanding, and use of disclosures and communications regarding consumer financial products or services;
- (D) consumer awareness and understanding of costs, risks, and benefits of consumer financial products or services;
- (E) consumer behavior with respect to consumer financial products or services, including performance on mortgage loans; and
- (F) experiences of traditionally underserved consumers, including un-banked and under-banked consumers.⁹

The CFPB's resources and access to data will make its research division a hub for top-flight independent scholars who are trying to work together to understand how and why consumers become overindebted. Although good consumer finance research is happening in some federal agencies, most notably the Federal Reserve, these research departments understandably exist to serve the important regulatory aims of their sponsoring unit such as banking regulation. In contrast, the research arm of the CFPB works within an organization whose mission it is to further consumer protection. Instead of research that focuses on how consumer finance might affect other regulated systems, the CFPB will produce research that understands how consumer finance affects consumers. In a few years, we should have a much better understanding of whether particular financial products are most likely to lead to overindebtedness.

More than Just Outstanding Consumer Debt

It was not just rising consumer debt that led Congress to create the CFPB. Committees such as this one had heard Americans complain for years about abusive practices in mortgage lending, credit card lending, arbitration, debt collection, mortgage servicing, payday loans, and many other industries. The financial crisis of 2008 created a climate in which the political will finally existed to protect consumers from practices where companies profited, not by providing a better product, but by deception, confusion, and lack of information. With the collapse of the

⁹ 12 U.S.C. § 5493(b)(1).

subprime lending market, it is tempting to think that abusive practices around consumer financial products have disappeared and that the need for an organization like the CFPB has diminished. Since the CFPB was created, new problems have appeared, and old problems have become salient in new ways. At the risk of creating the misimpression that the challenges are limited by mentioning only a few specific problems, I will list three current areas of concern in which an effective CFPB could play a role.

Reverse mortgages allow older persons to draw on equity they have in their homes and receive a stream of payments to help with expenses in their retirement years. To make an informed decision on a reverse mortgage, a consumer needs a good understanding of the value of the home, life expectancy, and a competitive interest rate. All of these pieces of information require estimation. Moreover, we can expect consumers to display bias in making these estimates such as overestimating the value of the home or life expectancy. In addition, persons contemplating a reverse mortgage often have liquidity constraints that create pressure to agree to the reverse mortgage. Some of the same players in the subprime lending market have moved into reverse mortgages, leading to complaints from consumer advocates that were similar to the complaints about subprime lending. Reports of high fees and financial products inappropriate for the consumer are becoming more and more frequent in the reverse mortgage industry, which seems poised to become the next big consumer lending problem area.

Mortgage servicing problems have dominated the news. Borrowers and even their attorneys are unable to reach a person at mortgage servicers who can negotiate a reasonable solution. Paperwork mailed to servicers gets lost or goes unacknowledged. Court affidavits have been mass-produced and signed by persons with little knowledge over the facts alleged in the affidavit, a problem now known as “robo-signing.” Community-based foreclosure mediation programs founder for want of funds and participation by both borrower and lender. Foreclosed properties, wanted neither by the bank or the homeowner, sit vacant and become a blight on the urban landscape.

Finally, debt collection abuses appear to be becoming more prevalent. Credit card collections may have replicated the robo-signing problems in the mortgage servicing industry. Indeed, given that many of the same players are involved and that credit card debt is sold in

ways that is similar to mortgage debt, it would be surprising if the debt collection industry did not have robo-signing problems. Other debt collectors have left families who have lost relatives with the incorrect impression that the family is legally responsible for the debts of their deceased loved one. In some areas, reports have surfaced that creditors act in concert with local courts to abuse procedures known as “body attachments” where a debtor can be arrested for failure to answer interrogatories related to a debt collection. When called into court, the technical nicety of being arrested for failure to answer interrogatories, as opposed to nonpayment of the debt, is lost on the debtor. Instead, the creditor or the court will tell the debtor he or she can go free if the debtor starts making payments on the debt.

Abuses in reverse mortgages, mortgage servicing, and debt collection are just a few of the current problems that demonstrate how a comprehensive federal regulator can help protect consumers. Responsible companies in these industries should welcome the oversight of the CFPB to rid the industries of bad actors. Three years into the financial crisis, it can be easy to forget the conditions that led to the creation of the CFPB. It is important that short political memories not hobble an important tool for American consumers just after it starts.