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A RESPONSE TO PROFESSOR LEVITIN ON THE EFFECT OF THE CONSUMER FINANCIAL PROTECTION AGENCY ACT OF 2009 ON CONSUMER CREDIT

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George Mason University Law and Economics Research Paper Series

09-56

A Response to Professor Levitin on the Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit

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3 November 2009

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The Consumer Financial Protection Agency Act ("CFPA Act"), introduced by the U.S. Department of the Treasury in June 2009, proposes sweeping regulation of consumer lending and borrowing. As we showed in *The Effect of the CFPA on Consumer Credit* (hereinafter "Evans and Wright (2009)"):[1]

- The CFPA Act creates massive litigation exposure for lenders facing (a) potential lawsuits from state and municipal governments for violating more stringent financial protection regulations that those entities can adopt pursuant to the CFPA Act; and (b) litigation under the CFPA Act's new and undefined standards for engaging in unfair, deceptive, abusive, or unreasonable practices.

- The new Agency would impose significant costs on lenders who would be required to: (a) offer to consumers on a preferred basis plain-vanilla products designed by the Agency either before offering their own products or at the same time; (b) seek prior regulatory approval for new lending products which could be defined as minor variations on existing products; (c) face the risk of having lending products banned altogether; and (d) have to comply with various other rules and regulations.

Our analysis of the CPFA Act shows that it would raise costs to lenders, which would naturally be passed on to borrowers in the form of higher interest rates and fees. As the result of these higher interest rates and fees, the CFPA Act would result in the withdrawal of credit to some borrowers, particularly those with higher risks of default. The CFPA ultimately would, as envisioned by its proponents, prevent consumers from borrowing money when and how they want to.

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[1] David S. Evans and Joshua D. Wright, *The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit* 37-43 (George Mason University School of Law, Research Paper No. 09-50, October 6, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1483906. That paper and this one focus on the original CFPA Act of 2009 proposed the Treasury Department. UNITED STATES DEPARTMENT OF THE TREASURY, CONSUMER FINANCIAL PROTECTION AGENCY ACT OF 2009 (2009), *available at* http://www.financialstability.gov/docs/CFPA-Act.pdf [hereinafter CFPA Act] (proposing 2009 Consumer Financial Protection Agency legislation for passage by Congress). The reforms of consumer financial protection and the proposal to create a single agency were presented on July 17, 2009 in 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).

This note responds to a recent paper by Professor Adam Levitin offered in response to Evans and Wright (2009).[2] As a prefatory matter, his paper is filled with various *ad hominem* attacks which we will ignore. Instead, we focus on the substance of the issues in contention. Levitin's basic substantive objection is that he disagrees with our estimates that the Treasury Department's bill would increase interest rates by at least 160 basis points and reduce net job creation by 4.3 percent under plausible assumptions. We discuss these points in about 5 pages of our 51 page paper. As we will explain below, his criticisms are misguided and we stand by those numbers as *lower bounds* on the effect of the Treasury's CFPA Act on the economy. For purposes of absolute clarity, we would like to reiterate that the estimates we provided are neither pessimistic projections nor precise targets: they are the most minimal quantum of harm we expect the CFPA Act, as currently envisioned, would cause. Before explaining our findings and Professor Levitin's criticisms, it is worth observing what Professor Levitin has not done.

Professor Levitin has disputed virtually none of our findings that the CFPA Act would impose high costs on lenders and ultimately result in denying borrowers choice. He claims that "better regulation of the consumer credit market would result in *lower* cost of credit" on the grounds that better disclosure would provide more vigorous price competition in the marketplace.[3] Levitin fails, however, to provide any evidence in support of this claim despite the many past regulatory efforts to improve disclosure.[4] Moreover, Levitin does not address any of the other aspects of the CFPA Act that clearly impose costs on covered firms (which we discuss below). We think it is impossible to read the CFPA Act without concluding that lenders will face higher costs as a result of, among other things, dealing with the new Agency, being forced to offer products designed by a governmental body rather than themselves, coordinating the sale and distribution of financial products across regulatory regimes varying across the fifty states, and facing the increased possibility of fines and litigation under a novel and ambiguous "abusive" practices standard. While we believe there is a debate to be had on the costs and benefits of the CFPA Act, it is difficult to fathom a claim that this particular Act will not impose significant costs on lenders and that those costs will not be passed on to borrowers.

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[2] Adam Levitin, *A Critique of Evans and Wright's Study of the Consumer Financial Protection Agency Act* 1 (Georgetown University Law Center, Public Law Research Paper No. 1492471, October 22, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1492471.

[3] *Id* at 4.

[4] *Id*

As we explain in Evans and Wright (2009), one of our greatest concerns is that the CFPA Act proposes a fundamental change in the law on consumer protection.[5] The CFPA Act makes it possible for states and municipalities to impose more stringent regulations on nationally chartered banks. To put this in perspective, we described in our paper the massive increase in regulations and litigation that resulted from the rather simple Truth in Lending Act.[6] In addition to eliminating federal preemption, the CFPA Act unsettles decades of consumer protection jurisprudence. Rather than relying on settled law on "unfair and deceptive practices" via the Federal Trade Commission's interpretation of similar authority under Section 5 of the Federal Trade Commission Act, the CFPA Act *explicitly rejects* harmonization with the Federal Trade Commission and allows the agency to come up with its own interpretations of "unfair and deceptive practices." Moreover, the CFPA Act adds two new, undefined violations: acts involving "abusive" or "unreasonable" practices. Thus, the CFPA Act as currently envisioned creates three new sweeping terms ripe for litigation: the meanings of "unfair and deceptive," "abusive," and "unreasonable" practices. Despite this, Professor Levitin confidently announces that these fundamental changes are neither problematic nor will result in a consequential wave of litigation. Professor Levitin offers no support for this conclusion. He then goes on to predict – also without support – that issues concerning legal uncertainty will be resolved out of court, that states (with divergent and competing interests) will adopt consistent regulations, and that even if they do not, industry will (apparently at little cost) "respond by conforming with the strictest level of regulation."[7] Professor Levitin, of course, addresses neither the implausible assumption that States will adopt regulations that harmonize with one another's public policy – one can

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[5] Evans and Wright, *supra* note 1, at 7.
[6] *Id*. at 40.
[7] Levitin, *supra* note 2, at 3. Levitin also puzzlingly declares that the CFPA Act "does not create any new substantive regulation." *Id*. As discussed at great length in Evans and Wright (2009), even if one ignores the "plain vanilla" provision (which may or may not appear in the final version of the legislation), the "abusive" conduct standard is surely new. As discussed above, the CFPA Act also specifically rejects harmonization with existing interpretations of the "unfair" and "deceptive" practice standards under the Federal Trade Commission Act. Further, contrary to Levitin's assertion that state regulation is likely to be consistent in the presence of an active and competent federal regulator, state consumer protection legislation exhibits dramatic variation despite the presence of the Federal Trade Commission, at least in part due to varying judicial interpretations standards like those in the CFPA Act. *See, e.g.*, Henry N. Butler & Jason S. Johnston, *Consumer Harm Acts? An Economic Analysis of State Consumer Protection Acts* (Northwestern University School of Law, Law & Economics Research Paper No. 08-02, April 24, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1125305.

envision, say, California and Delaware expressly declining to do so – nor what would become of marginal consumers who, living in a more market-oriented state, are nonetheless denied credit products due to a foreign jurisdiction's regulations.

The Treasury Department's CFPA Act as analyzed in Evans and Wright (2009) is widely acknowledged to be an extremely intrusive intervention into the markets for borrowing and lending. The Treasury Department and the Democratic Party have both recognized that many pieces of the original legislation were dubious and have consequently modified or backed away from them. For example, with regard to the "plain vanilla" feature, Treasury Secretary Timothy Geithner backpedaled from his original support, saying, "There has been a lot of concern that if you invest the government with the ability to decide what's appropriate here and there, that will lead to less competition and choice. The chairman's proposals [which eliminate plain vanilla] . . . provide a better balance of choice and protection."[8] The original legislation required that lenders be "reasonable." Chairman Barney Frank noted that the CFPA Act's "reasonableness" standards "would place financial institutions in the untenable position of having to assess whether consumers comprehend the products and services they are being offered."[9] There is less of a consensus on federal preemption provisions. However, Representatives Melissa Bean (D, IL), Jim Himes (D, CT) and other moderate Democrats in Congress introduced an amendment that would retain federal preemption.[10] It may well be that as the CFPA Act moves through Congress, other aspects of the initially proposed legislation will be modified that will reduce its impact on borrowing and lending. These concessions make it quite apparent, however, that that original bill was a highly intrusive and unreasonable intervention into the business of borrowing and lending.

How, then, would the CFPA, as originally envisioned, impact consumers, small businesses, and lenders? It is clear based on our analysis – which Levitin largely ignores – that it would be significant. Levitin is correct that any forecast of the impact of the bill is necessarily

[8] Stephen Labaton, *White House Pares Its Financial Reform Plan*, N.Y. TIMES, Sep. 23, 2009, http://www.nytimes.com/2009/09/24/business/24regulate.html.
[9] Memorandum from Barney Frank, Chairman, House of Representatives Committee on Financial Services, to Democratic Members of the House of Representatives Committee on Financial Services (Sep. 22, 2009), *available at* http://blog.prospect.org/blog/weblog/FrankCFPAMemo.pdf.
[10] Victoria McGrane, *Frank Gets Moderates to Relent*, POLITICO, Oct. 20, 2009, http://www.politico.com/news/stories/1009/28493.html.

speculative. We stated as much in our article.[11] But, aside from the counterintuitive and completely unsupported claim that the Treasury's CFPA Act would reduce the cost of credit, Levitin presents no analysis whatsoever of the costs and benefits of this important piece of legislation. In this, Levitin is not unusual: no proponent of the CFPA Act, to our knowledge, has presented any analysis of the costs and benefits of the proposed legislation. In carefully qualified language, we looked at evidence that would help us place a *lower bound* on the cost of the CFPA Act under plausible assumptions. We now turn to that evidence and to Professor Levitin's subsequent criticisms.

One way to understand the possible impact of the Treasury's CFPA Act is to examine other shocks to the lending industry. As we noted in our paper, a major part of our concern about the CFPA Act's impact on lending costs is that the Act will result in significant state-by-state variation in regulation, which will necessarily impose increased transaction costs on lenders. Intuitively one might immediately observe that the greater the variation amongst states, the greater these costs will necessarily be. As we explain at length in our paper, we chose to analyze the "IBBEA shock" as the IBBEA did precisely the same as the proposed CFPA Act would do: it ended federal preemption, causing a proliferation of divergent state laws.[12] Necessarily, of course, costs to lenders increased. The IBBEA shock alone resulted in an 80-100 basis point increase in interest rates. In the case of the CFPA Act, we would expect that the state-by-state regulations will result in changes in the both the type and extent of competition on the state level as national lenders withdraw from some states. The IBBEA regulatory shock, however, did not have any of the other aggravating elements we observe with the CFPA Act – such as fundamental changes in legal standards, a new agency requiring lenders to provide products designed by the agency that interfere in consumer choice, a "reasonableness" standard

[11] Evans and Wright, *supra* note 1, at 46 ("We take this 80 basis point penalty as a lower bound on the effect that the CFPA Act would have on interest rates."); *Id*. at 47 ("Combining these estimates, we can generate a rough prediction of the impact of the CFPA on interest rates and credit supply . . ."); *Id*. ("We report estimates based on the CFPA Act having the same, twice, and three times the impact on interest rates as the state-imposed geographic branch restrictions studied by Rice and Strahan. Those estimates imply that the CFPA Act would increase interest rates by 80 basis points if the impact of the CFPA Act's regulations was the same as the geographic restrictions, 160 basis points if the impact of those regulations was twice as costly and 320 basis points if it was three times as costly. We take 160 basis points as the likely lower bound on the effect of the CFPA Act on interest rates.")

[12] Evans and Wright, *supra* note 1, at 47-48 (outlining the IBBEA and comparing notable similarities between the IBBEA and the proposed CFPA Act of 2009).

that requires lenders to guess what consumers understand, an agency that imposes costs for introducing new products, and so forth. We began with the *lowest* end of the IBBEA shock – 80 basis points – and then proceeded to analyze and document the various cost-increasing features of the CFPA Act in practice to compare costs. Based on the analysis in our paper, we believe the answer is a multiple of the cost of the IBBEA shock. We took the extremely conservative multiple of two and continue to believe that is a lower bound on the true effect of the CFPA Act on consumer credit. Contrary to Professor Levitin, we presented this figure as a lower bound and not a "precise statistical estimate" and carefully qualified it as such in our original paper.

It would be more constructive for Professor Levitin to explain, theoretically or practically, how the highly intrusive elements of the Treasury's CFPA Act could possibly *avoid* an increase in lending costs that will be passed on to borrowers. The basis for that answer cannot possibly be that some of the more offensive features have been eliminated, since then we would be comparing a known orange (the Treasury's CFPA Act proposal from June 2009) with an unknown apple (some version of the bill that might be proposed and ultimately adopted). Furthermore, such a response would inherently implicitly concede that the struck portions would have in fact increased lending costs – something Professor Levitin's critique adamantly denies. Our analysis demonstrates quite clearly that the cost of lending will increase as a result of both the CFPA Act provisions that at least presently remain "on the table" and those that have been withdrawn. It further demonstrates that the CFPA Act will reduce the availability of credit to consumers and small businesses, especially to high risk borrowers including likely socially and economically disadvantaged ones.

Professor Levitin also critiques our analysis of the impact of the CFPA Act on the creation of jobs by *new* businesses which usually start out small. We can afford brevity on this point because he is patently wrong.

First, Professor Levitin expresses confusion that we are claiming that small businesses would be affected since the CFPA does not cover small business lending.[13] This reaction, of course, was expressly addressed in our paper, where we noted that about half of small businesses

[13] Levitin, *supra* note 2, at 5.

rely on consumer lending products.[14] These businesses borrow on credit cards, home equity loans, auto title loans, and so forth. They do so, of course, because it is easier – stated another way, the time and effort costs are lower – than applying for business credit.

Second, Levitin disputes our claim that *new* firms with less than 20 employees accounted for 86.7 percent of new jobs created in the U.S. The bulk of net new jobs are created by *new* firms who, of course, are the ones who are most in need of novel sources of credit. Our figure of 86.7 percent focused on *new* firms that started with fewer than 20 employees.[15] Levitin's figure is smaller because he focused on *small* businesses instead of *new* businesses; many of these newer businesses are mature ones that have established credit records but that also do not account for much job creation. The new small businesses — which would have notably included Google, whose founders relied on their personal credit cards — sometimes grow into very big businesses. We describe in detail in our paper why it is plausible that more than five percent of these new businesses could be denied the credit necessary to start. Most new businesses face liquidity constraints which make it very difficult for them to find any source of funding. The CFPA Act necessarily makes it harder for lenders to tailor loans for high-risk borrowers, which, of course, would include these small business owners. The provisions of the CFPA Act would enable the Agency to prohibit various kinds of lending products. This is neither coincidental nor theoretical: the proponents of the CFPA Act who would most likely have a lead role in how the Agency would function have expressed a desire to prohibit various kinds of lending products which new businesses rely upon in resolving liquidity constraints.

Professor Levitin identifies the speculative nature of any estimate of the impact of the CFPA Act on consumer credit as his real objection to our analysis: "The key point here, however, is the impact of the legislation is speculative and certainly not susceptible to precise statistical predictions."[16] That is a nihilistic approach. Congress is being asked to pass a far-reaching piece of legislation that would intrude into many aspects of lending and borrowing

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[14] Evans and Wright, *supra* note 1, at 48-49 (expressly addressing that small businesses rely on consumer lending products and analyzing likely harms to small businesses as a result of the CFPA Act).

[15]The figure in Evans and Wright (2009) is for 2005 and not for 1987-2005 as misstated there. In 2005 net job creation at new firms with less than 20 employees was 2,151,513 while total net job creation across all firms was 2,481,097. See US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Firm Age By Firm Size, available at http://www.ces.census.gov/index.php/bds/bds_database_list. Over the period 1987-2005 the net new jobs (taking jobs created minus jobs lost) by new firms with less than 20 employees exceed total net new jobs because many older and larger firms had net job destruction.

[16] Levitin, *supra* note 2, at 3.

decisions. It seems to us that Congress should think carefully about the *costs* of doing so in addition to evaluating any perceived benefits. Declaring that the CFPA Act is completely unpredictable seems neither helpful nor a persuasive defense of the bill. The IBBEA study provides some information on the effect the introduction of a minor inconsistency amongst states in lending regulation and competition. As we've argued, even a cursory reading of the CFPA Act reveals both that the costs it will impose on lenders associated with the inconsistency amongst states as well as its substantive provisions will be substantially greater than those imposed by the IBBEA. Thus, the IBBEA experience is quite useful for placing a *lower bound* on the likely effects of the CFPA Act. If Professor Levitin has something more substantial than his unsupported claim that CFPA Act will reduce the cost of credit he should offer it. Likewise, it is inconceivable that the CFPA Act would not (for the same reasons) result in the denial of credit to some small business owners. Based on our analysis of the CFPA Act, we think a 5 percent reduction is plausible. Even if it is only a 1 percent reduction, however, would be an enormous number of lost jobs at precisely the wrong time for the U.S. economy.

Finally, Professor Levitin writes that, "Evans and Wright have apparently forgotten why we need a financial recovery. It was because financial institutions made lots of ill considered consumer loans that hurt the institutions, consumers, and country when they failed. A CFPA would not regulate consumers. It would regulate financial institutions. If we have learned anything from this debacle it is that banks need a supernanny."[17] Contrary to Levitin's assertion – which again asserts without a scintilla of evidence that failures of consumer protection caused the financial crisis – Evans and Wright (2009) provided a lengthy and detailed discussion on exactly this point. Indeed, we agree that there may well be reasons why consumers would benefit from greater protections, and perhaps there are reasons why some aspects of the CFPA Act of 2009 might be worth considering. Reasonable cases could be made for why—as we believe—currently unregulated firms should be subjected to existing consumer financial protections, and a case can be made that some consolidation of regulatory responsibility is desirable.

As we explain in great detail in our earlier paper, however, there is *no evidence whatsoever* that failed consumer protection was the cause of the financial crisis.[18] We repeat:

[17] *Id*. at 5.
[18] Evans and Wright, *supra* note 1, at 31-32.

Professor Levitin's claim that a failure of consumer protection law precipitated the recent and current financial crisis is completely without evidentiary support. Neither Professor Levitin nor anyone else to our knowledge has provided any evidence that the financial crisis would have been averted if there had been consumer protection regulation along the lines suggested by the CFPA Act. There is broad consensus that the financial crisis resulted largely from a "housing bubble". The collapse of the housing bubble together with the decision by financial institutions to hold onto portions of mortgage backed securities resulted in financial institutions falling like dominos. Some subprime mortgages would not have been issued had there been greater oversight over mortgage brokers. There is no evidence, however, that such oversight in a "consumer protection" context would have made much of a difference. Most of these loans seemed subjectively sensible to both the lenders and borrowers in light of the collective delusion that housing prices would keep going up. We understand Professor Levitin supports a supernanny agency and has argued for some time that there are profound problems in the lending business. One can debate those views. But to ascribe to this new supernanny the merits of lowering costs or preventing the recent economic downturn is wishful thinking at best and plainly inconsistent with the evidence.

We believe all readers can agree that the CFPA Act of 2009 is an important piece of legislation which will have, for better or worse, far-reaching effects on how consumers borrow and how financial institutions lend. We can also all agree that whatever its connection to the financial crisis there are sound reasons to consider improvements to the current regime of consumer financial protection. Sound public policy should be based on a careful analysis of the costs and benefits of the various proposals. We do not believe Professor Levitin has made a constructive contribution to that deliberation but encourage him and others to do so as Congress considers the CFPA Act of 2009.