

David A. Lander

Judiciously provided and employed, consumer credit has significant benefits to the lender, to the investor whose dollars are being lent, to the consumer borrower, and to the economy and society. Even under the best of circumstances, however, consumer credit carries risks that vary from broken knees to homelessness to economic catastrophe (i.e., 1929 and 2007). The periodic swaying of the pendulum of consumer credit availability from too little to too much has enormous sociological and economic consequences on both a micro and macro basis.

We have recently lived through a turning of that pendulum. Between 1980 and 2005, an explosion occurred in dollars available to lend to consumers, in the dollars actually lent and borrowed, and in the ratio of consumer debt to income (Bricker, Kennickell, Moore, & Sabelhaus, 2012; Bricker et al., 2014). There is dispute regarding the behavioral underpinnings of the demand side of the equation. Have the increased costs of survival forced consumers to use increased credit to plug the holes in their safety net (Warren & Tyagi, 2003), are consumers choosing to purchase luxuries they cannot afford and ought not to buy (Schor, 1998), or are they hyperbolic discounters (Angeletos, Laibson, Repetto, Tobacman, & Weigberg, 2001)?

Growth in consumer credit in the USA was staggering and changes in the nature of the borrowing vehicles were striking. This explosive growth in the amount of consumer credit between 1980 and 2006 combined with deteriorating debt quality had massive economic and sociological consequences on individual households, the health of financial institutions, returns on investment capital, and the American economy and society. The consequences were both micro and macro, ranging from extraordinarily positive to devastatingly negative (Maki & Michael, 2001) and constituting both the cause and the result of structural change in our economic and social systems (Xiao & Yao, 2014).

Twenty five years earlier the elimination of controls on the price of borrowed money had: (a) created a profit opportunity for lenders and investors; (b) opened the door to allow millions of high credit risk Americans to become purchasers of credit; (c) allowed medium risk Americans to borrow to the point that they became high risk Americans; and (d) allowed Americans to purchase homes that were beyond their reach. As more American consumers became homeowners and as the paper value of their homes increased, that paper equity became a port of entry into the world of home equity extraction lending which allowed consumers to borrow more than would have been available from their credit card lenders. This, of course, put their homes at risk. The fact that the infusion of this overleveraged borrowing fueled the USA boom economy was a primary factor in the unwillingness to regulate.

---

D.A. Lander, J.D. (✉)  
St. Louis University, School of Law School,  
12372 Woodline Drive, St. Louis, MO 63141, USA  
e-mail: [CDLander@Charter.net](mailto:CDLander@Charter.net)

This same failure to regulate the onslaught of new and dangerous mortgage products from 2000 to 2007 enabled a feeding frenzy for consumers, investors, mortgage brokers, and rating agencies. One goal of consumer credit regulation is to prevent the crash which follows such a frenzy.

Then between 2007 and 2009 it all crashed into the worst and longest lasting economic debacle in the USA since the Great Depression, which it mirrored or surpassed, said the former Federal Reserve chairman, Ben Bernanke (Da Casta, 2014). During and immediately after the crash, consumer credit dried up partially due to reluctant lenders, reluctant investors, reluctant borrowers, and reinstated regulatory pressure (The Bond Buyer, 2013). Indeed, credit card debt has hardly budged from its crash-induced nadir (New York Federal Reserve Bank, 2014). Mortgage debt has inched upwards, auto debt is increasing steadily, and student loan debt has exploded. The crash induced the Federal Reserve Board to create new credit card rules and induced Congress to enact those restrictions into law. The temporary panic induced Congress to create a new watchdog, the Consumer Financial Protection Bureau (CFPB), which has taken steps to construct a revitalized and more creative regulatory construct.

In view of the recent crash and the nascent efforts of the CFPB, it is a propitious time to evaluate the regulation of consumer credit in a world that has recently experienced the consumer lending revolution (FDIC, 2003), the mortgage lending revolution and the worldwide crash that followed, but a world that seems to require credit-fueled consumer spending to make the economy healthy. The crucial question for those who set consumer regulatory policy is, if there is no limit on the cost of credit, if it seems profitable to lend in ways that assure high rates of default, if the societal message is to “borrow to meet your needs/wants,” and if such unlimited borrowing and lending will lead to both benefits and damage to individuals and to the economy and society then what regulations, if any, should be imposed? Policy makers must understand and consider the micro and macro economic and sociological benefits and detriments of the consumer lending explosion and then determine how to fashion rules and

regulations in a manner that encourage the positive and discourage the negative economic and sociological effects of consumer credit.

---

## Growth of Consumer Credit

The primary stories of the growth and fall of consumer credit in the 34 years since the dismantling of usury limits are (1) the growth of third-party credit card debt, (2) the emergence and ensuing explosion of subprime debt, some portion of which is referred to as predatory lending, (3) the huge growth in home mortgage debt, purchase-money and non-purchase-money, prime and subprime, and (4) the explosion in student loan debt.

## Credit Card Debt

In the late 1970s, partly in response to a United States Supreme Court case and high inflation, the legislative atmosphere at both state and federal levels changed dramatically and in the span of the next decade usury restrictions were rolled back and practically eliminated. As a result it became profitable to lend to higher risk consumers (Ellis, 1998).

From a market that had been richly diversified prior to 2003, the top five credit card lenders had 50 % of a much larger market and the top ten held 83 % of that market. This consolidation was caused by the need to achieve scale and resulted in vastly improved credit scoring and collection techniques, which led to more profitable lending even to higher risk consumers (FDIC, 2003). Lending to more highly leveraged consumers of course led to an increase in defaults; and higher costs and fees, and interest rates for the late-paying customer have grown in importance. For the lender the most profitable customer is the one who pays but pays slowly (Pacelle, 2004). As consumer lending became more profitable during the 1990s, additional capital was increasingly drawn to the industry and a secondary market began to function efficiently. As a result there was an explosion in the dollars available to lend.

As the volume of credit card debt increased, lenders worked hard to develop new customers. In 2006, approximately eight billion pieces of promotional mail were sent to prospective customers. Lenders developed innovative ways to convince customers to shift to their card or to refrain from shifting away from their card. At the same time they implemented equally innovative methods of making the largest profit possible off of those consumers who paid, but paid late.

Shortly before the crash, several credit card companies began to modify selected practices; about that time the Fed promulgated a series of important reforms, including a ban on charging default interest on the basis of a default on a different credit card obligation. In a sign of the anti-credit card atmosphere in the wake of the crash, Congress passed legislation which largely reflected the Fed rule changes. The CFPB has focused attention on credit card practices.

Credit card indebtedness per household fell from \$8472 in 2006 to \$6734 in 2011. Factors included: restriction of credit standards by lenders; reluctance or inability of consumers in financial distress to borrow on their credit cards; write offs by lenders; the emergence and growth of traditional and pre-paid debit cards; and the contraction of the supply of dollars to lend as securitization-burned investors closed their wallets. Since that time, balances on neither traditional products nor subprime credit cards have rebounded (New York Federal Bank, 2014).

As of March 2014, credit card debt is currently holding fairly steady. On the one hand, higher consumer spending would put the economy on a more positive track; higher spending could also lead to more jobs and higher incomes, which can in turn lead to even higher spending, a sign of the good times. However, if wages and employment are not keeping pace, higher debt might well be an indication that families are borrowing to make ends meet rather than a reflection of a well-founded increase in consumer confidence. As consumer confidence and balance sheets improve, the pressure to borrow on credit cards will increase although the emergence of debit cards appears to have diverted some of this demand (Levenger, & Zabek, 2011). Financial institutions have created

borrowing-like features of debit cards such as overdraft fees and the CFPB will need to continue to scrutinize and regulate such efforts to turn pay now into pay later.

### **The Subprime Products Other Than Mortgage Products**

As of 2014, there were 9800 rent to own stores serving six million customers and generating \$8.5 billion dollars in revenue and 20,600 payday advance locations in the USA providing \$38.5 billion in short term credit to 19 million households. Borrowing on subprime credit cards and subprime auto loans skyrocketed (Kirsch, Mayer, & Silber, 2014). Certain areas of state regulation may be pre-empted if there is Federal regulation that covers the field entirely. Often, however, one must wade through a crazy quilt mix of state and federal law in order to understand the rules that govern a particular transaction.

Americans who were deemed excessive credit risks by pre-1978 mainstream lending standards had always borrowed limited amounts from salary lenders, pawnbrokers, high finance furniture dealers, rent to own businesses, street lenders, and family members. The elimination of usury legislation, however, and the development of sophisticated risk-scoring techniques turned a significant portion of those who had not been considered creditworthy into desirable customers for mainstream lenders on subprime terms. With the development of capital sources, sophisticated pricing techniques, and sophisticated marketing mechanisms, mainstream lenders and newly capitalized, publicly held, subprime only lenders entered the field with both feet and immediately began to probe the outer limits of the profitability of this type of lending. They began to explore whether there was any upper limit on credit card interest rates, or on post-default interest rates and charges (Montezemolo, 2013).

This lending might involve a credit card with a higher cost or a credit card secured by a car or other property. It might involve financing and the sale of used cars at very high prices to poor credit

risks or the “car title” method of lending which eases the rules for taking possession and the title to the repossessed vehicle. This lending might include “payday loans” or other very short term loans at very high rates that are often rolled over. It might also include renting to own at very high prices or tax refund anticipation loans.

Consumer advocates have begun to have some limited success convincing state and federal regulators to ban or restrict practices that are deemed predatory, particularly for vulnerable and special populations such as members of the military. Some states such as North Carolina have been serious about regulating subprime lending to ensure that it is not predatory. In addition, the CFPB has initiated certain supervisory and enforcement activities in the Payday Loan arena. A wave of money is pouring into subprime auto lending, as the high rates and steady profits of the loans attract investors. Just as Wall Street stoked the boom in mortgages, some of the nation’s biggest banks and private equity firms are feeding the growth in subprime auto loans by investing in lenders and making money available for loans.

One set of voices calls for elimination or severe limiting of this supply line (Center for Responsible Lending, 2014) while another believes that subprime devices are essential sources of needed dollars by those frozen out of conventional financing (Mann, 2013). The CFPB is in the early stages of asserting control over payday lending and is seeking to strike an effective balance. Consideration is also being given to “substitution” of lower cost lenders such as the Postal Service.

### **Mortgage Debt: Purchase-Money and Non-Purchase-Money**

Home mortgage debt constitutes 80 %, the overwhelming majority, of all consumer debt and is the primary macroeconomic factor in consumer lending. During the period from 2000 to 2006, several factors combined to produce significant changes in the nature of mortgage debt, particularly among those homeowners with lower incomes and lower net worth:

1. Home ownership increased to 67 % of American households.
2. Home values rose. The price of the average house increased significantly faster than average disposable incomes every year between 2001 and 2006, a historically unusual event. Values rose at significantly different rates in different parts of the country.
3. Interest rates were at out-of-market and historically low levels.
4. Americans refinanced repeatedly at very low rates to reduce their monthly mortgage payments, putting large amounts of money in the hands of American homeowners (Brady, Canner, & Maki, 2002; Canner, Dynan, & Passmore, 2002; Krainer & Marquis, 2003; McConnell, Peach, & Al-Haschim, 2003).
5. The combination of low interest rates, rising home values, the higher costs of other types of debt, and relaxation of other regulatory restraints contributed to make withdrawal of equity immensely more popular than ever before (Canner et al., 2002).
6. As more and more home owning households sought to borrow beyond their historic credit limits, either to purchase a first home at increased prices or to shore up their financial condition, lenders found new ways to relax credit limits so they could sell more and more of their products to a hungry buying public. Innovative products included teaser rates, interest only loans, and special types of adjustable rate mortgages; all of this accompanied by no documentation or low documentation credit standards.
7. The investment community’s search for ever higher returns and more creative vehicles continued to pour dollars into the system to provide the supply to meet the demand. Indeed the availability of those dollars in the private securitization market was perhaps the most important contributing factor.
8. Mortgage lenders replicated the actions of the credit card lenders of the 1990s and expanded their outreach to consumers with lower and lower credit scores.
9. The rating agencies lost track of their responsibilities for evaluating and grading the transactions and borrowers contained in the securitization packages.

The equity in a person's home is the primary source of savings or reserve for most Americans. Between 2001 and 2006, the so-called cash-out refinancing—taking out a new mortgage larger than the one being paid off and pocketing the difference—netted consumers about \$250 billion per year of immediately available spending power. This was equivalent to about 3 % of the disposable income of all US households in each year and, obviously, much more for those households doing the refinancing (Klywev & Mills, 2006).

Mortgage debt increased from about 40 % of disposable income in 1970 to 60 % in 1990 to about 83 % as of 2003 and continued to explode until 2006. The rise in home prices and the elimination of underwriting standards combined to allow consumers to borrow ever increasing amounts. Teaser rates allowed most but not all consumer borrowers to make the first payments; when market rates became effective it was clear to all that the borrowers would not be able to make the payments. So long as prices continued to rise the borrower could refinance or sell the home. However, once the price escalation slowed down, massive defaults were inevitable.

Then in late 2006, the subprime market imploded; partly because the rise in home values slowed and then stopped in many markets and the pressure cooker could not function without this safety valve, partly because investors began to be concerned about the rising number of defaults even when house prices were still rising. That crash caused a 1929-like set of chain reaction spirals which reinforced one another.

## Student Loan Debt

Added to all of this has been the extraordinary increase in student loans. In just a few years student loan debt surpassed auto debt and past credit card debt. Auto debt, particularly subprime auto debt, increased markedly between 2000 and 2006, decreased markedly between 2006 and 2010 and has begun to rise rather significantly in 2014 (Federal Reserve Bank of New York, n.d.).<http://www.newyorkfed.org/regional/householdcredit.html>.

## Sociological and Economic Consequences

### Sociological Consequences

The key benefits of various consumer credit vehicles are readily apparent; they may provide a bridge to a better place. A person needs a car to be able to get to a new job, but cannot afford the car until she has been working the new job and perhaps until after she obtains one or more promotions in that job. She buys the car on high-cost credit, takes the job, gets the promotion, and her life is much better. Without credit she could not have bought the car and would remain without a job or in her former inferior job.

A person needs housing in a safer neighborhood with better schools and cannot afford the move without the use of credit (Schor, 1998; Warren & Tyagi, 2003). Warren and Tyagi demonstrate that in most households all the adults who can work are working and their income is just enough to support the family. If they happen to encounter turbulence from loss of employment, health or family difficulties there is little wiggle room. Their data supports the notion that people are spending beyond their income because that is required in order to have a safe and reasonable life style. Caldor (1999) goes a step further to say that the pressure that emanates from greater debt drives people to work harder and to be more productive.

Two prominent sociologists, George Ritzer and Robert Manning say all of this is nonsense (Manning, 2000; Ritzer, 1995). They assert that inducing people to borrow more, loading them down with deceptive and excess credit, and then adding impossible default charges creates problems on both micro and macro levels. On the micro level, credit defaults, repossessions, and foreclosures increase stress and create more mental health problems and family abuse. Debt is a primary contributing factor to family disharmony and divorce (Shen, Abdoul, Sam, & Jones, 2014). Health suffers, employment suffers, and the reduction in happiness and life satisfaction cause a myriad of types of damage. On a macro level society must bear the consequences of more broken homes and dysfunctional families under the

stress of debt, more jails, more people needing mental health services and more children and mothers needing shelter from abuse and rehabilitative services, and higher taxes to pay for all of this. Millions of Americans labor under crushing debt loans that entrap them, shatter their dreams, and cripple their ability to save and increase assets. Fallout from the subprime mortgage crises has demonstrated that multiple home foreclosures in a neighborhood have a negative and deteriorating effect on other homes and community institutions in the neighborhood.

### Economic Consequences

High levels of troublesome types of consumer borrowing are one significant cause of economic catastrophe on both a micro and macro level, i.e., 1929 and 2007. In order to set the gauge on the optimal range of volume of consumer lending, regulators must understand the positive and negative effects of such borrowing and lending on the economy. The short term micro and macroeconomic consequences of the consumer lending revolution are each readily apparent. From 1980 through the crash in 2007, investors and investment banks profited enormously by the explosive increase in consumer lending. Financial institutions and other participants in the consumer lending stream became more profitable and their share price has increased. During the decade before the crash, the US economy and the world economy were based as never before on consumers' spending considerably more than they have and considerably more than many of them will ever be able to repay (Burhouse, 2003). The portion of the national economy that is driven by consumer spending rather than business or government spending increased to 77 % and spending by Americans is a primary support for the world economy. By comparison, 1960–1980 consumption held steady at 63 % of GNP. During the 1980s it rose to 66 % and was 66.5 % in 1997.

Beginning in 2006, there was a significant uptick in default and foreclosure. The scale of the economic debacle in the USA and most of the rest of the world was disastrous and had no precedent

since the depression of 1929. Many books have been written about what happened and why. For our purposes it is enough to say that the following events and actions occurred:

1. A surge of foreclosures;
2. A drying up of credit for refinancing or home purchases;
3. A drying up of appetite and wherewithal of consumer demand for any new debt and new purchases by any other than consumers in the first or second financial quintile;
4. A spiral of unemployment;
5. A nose dive in real estate values; and
6. Reluctance on the part of investors to return to the mortgage back securitization pools.

For the past several years each of these factors has eased up and very slowly moved out of the disaster zone. It is ironic that current predictions indicate that there is insufficient wind in the sales to bring the US economy back to health. The wind that existed pre-crash was induced by credit excesses that played a significant role in the crash.

---

### Toward Understanding Why The Demand Is So High

It is important for policy makers to understand the nature of the demand side of this equation. Angeletos and colleagues (2001) suggest most consumers are hyperbolic discounters and honestly intend to save and pay tomorrow and to spend today. If we assume that the consumer has real alternatives and is making choices that subject her to serious and unwarranted risks, then it is important to understand the behavior that leads people to make these unhealthy decisions. Until recently, economists have shrugged their shoulders when asked why a significant number of consumers seem to act against their financial best interests. To fill the gap, a different breed of social scientists have stepped up to understand the ways that consumers use credit and make decisions regarding purchasing. Called behavioral economists in the USA (Angeletos et al.,

2001) and economic psychologists in Europe (Lea, Webley, & Levine, 1993), they explore these issues. They have several theories. One is that human beings act in an irrational manner and therefore this spending and borrowing is not subject to classical economic analysis or explanation. A second theory is that people tend to be excessively optimistic regarding their long term prospects and therefore make short term decisions which are based upon false expectations over the long run. A third theory is that individuals simply have poor self control in the short run, and a final theory is that people lack both the knowledge and information necessary to make a thoughtful rational analysis of the proposed borrowing or spending and this lack of information and knowledge interferes with their rational decision-making. A combination of various human traits and conditions combine to render these motivations complex (Martin & Sweet, 2006). Current brain research may further illuminate the biological basis for such behavior. Opinions vary over whether intervention is wise or harmful. In a capitalistic economy it is incumbent on lenders to exploit weaknesses of potential purchasers of consumer credit. One goal of consumer credit regulation is to limit such exploitation (Bar-Gill & Warren, 2008).

---

### **Toward Understanding Why The Supply Is So High**

Once the rate caps evaporated, lenders began to probe the outer edge of profitability for lending. The investment community responded quickly and developed or modified existing vehicles to share in these attractive profit opportunities. Initially these investments were in real estate mortgages and took the form of bonds and other forms of debt issued by Fannie Mae and similar private public secondary market players. As credit card debt exploded, card issuers needed additional liquidity and the securitization market for credit card receivables grew correspondingly. Most of it was prime credit card debt, but the subprime credit card market provided both higher anticipated profits and higher risk.

As more and more consumers began to tap into their home equity and as more and more consumers needed to stretch further to purchase their first or next home, the subprime market began to take off and by 2006 its share of all new mortgages went from 5 % in 2001 to 16 % in 2006 (Chomsisengphet & Pennington-Cross, 2006). This occurred just as Fannie Mae was struggling with the after effects of a perceived scandal and Wall Street seized upon the void to profitably substitute purely private securitization vehicles to purchase the subprime debt. This presented opportunities for ignoring and eliminating the underwriting standards required by Fannie Mae. The result was that the ready supply of borrowers for these risky loans found a ready supply of capital. The crash brought to the surface, the level of risk in these investments and for a while significantly reduced the volume. More recently that volume resumed as investors continue to search for above market returns. The power of investors seeking an above-market return on their money cannot be overestimated (Hyman, 2011).

---

### **Intervention and Regulation of Consumer Credit**

So, how do State legislatures, the CFPB, and Congress decide whether to intervene in the consumer credit market? How do they decide whether and how to regulate or prohibit specific types of practices? One school of thought warns government to get out of the way of the market and stop playing parent to adult consumers. Another asserts that the consumer must be protected from mistakes that will damage her and the society and economy (Campbell, Jackson, Madrian, & Tufano, 2011).

Intervention might be appropriate in order to ameliorate the negative consequences that exploding credit brings to individuals (i.e., undue strain, shattered dreams, domestic difficulty, homelessness, and mental illness) and to society (i.e., increased mental health costs and increased need for intervention in family disputes). If a certain type of profitable credit device results in a default rate of 90 % then there would likely be

consensus that the distress and inefficiency of the credit device justified intervention, and likely prohibition. The negatively affected parties would be the lenders who were denied a profit opportunity, the investment community which is denied an opportunity for a rate of return based on this product; the 10 % of borrowers for whom this device is productive and who will not default; and finally, perhaps the other 90 % who default but who do not think they will default and who want the opportunity to try and succeed or try and fail. The positively affected parties would be the 90 % who will be spared the consequences of default; the friends, family, and neighbors of that 90 % who are also spared the indirect consequences of those defaults and the public and private safety net which would have been required to provide help to the defaulters.

A prophetic article by George Wallace (1976) divides the people who will be regulated out of any particular market into three categories: (1) those who would have chosen not to borrow even if they could and are therefore unaffected by the regulation; (2) those who would have chosen to borrow and would have defaulted; and (3) those who would have chosen to borrow and would not have defaulted. The philosophical question is whether to prohibit the third group from borrowing in order to protect the second group. If we decide it makes sense to intervene, what might that intervention look like? We start with what the commentators call “soft nudges.”

## Disclosure and Financial Literacy

The first of these soft nudges are financial literacy education and disclosure of information regarding the credit extension. The decision to provide education and disclosure is based on the common sense notion that the consumer would be more likely to act in her own self-interest if we bridge the knowledge and information gap between her and the lender and if she understands both the degree to which and the reasons why she may choose to purchase more credit than she can likely repay.

The unanswered question is whether such educational efforts are effective. There is a

fascinating debate between a key proponent of financial literacy education (see Anna Lusardi’s Blog and a critic, Lauren Willis, 2008). To date, empirical work does not show that financial literacy education “works” (Collins, 2013). In fact, there is no consensus on what “works” means in this context; are we seeking less borrowing or borrowing from a base of greater understand, are we seeking more frugal choices?

An underlying question is “what does she need to know and when does she need to know it?” Over the past few years the field of financial literacy has grown exponentially; there are programs in schools and programs aimed at adults. Is the lesson, don’t ever borrow? Is the purpose of the lesson to understand the costs of borrowing so that people will stay within certain limits? What about the person who is borrowing to pay her rent or put groceries on the table or to obtain an education, what is the lesson for her? And what about the hyperbolic discounter?

Would behavior change counseling/education be effective? As behavioral economists have begun to understand why consumers do not act more like the purely rational automatons that economists have assumed them to be, this information may be translated into well-defined counseling sessions based on helping the consumer understand and modify her likely dangerously “irrational” behavior. There has been very limited investigation of this type of change in financial conduct.

What about disclosure? In addition to literacy efforts, Congress and some states have passed various disclosure laws intended to help consumers make more informed decisions about credit. For example, truth-in-lending laws were enacted in the late 1960s to ensure that the consumer receives clear and conspicuous information regarding financing transactions. Very recently the CFPB has been concentrating its efforts on developing plain language concise disclosures that help consumers make informed decisions on whether to borrow and what the right type of borrowing instrument will be. Disclosure legislation has been a mixed bag. For example, we do know that many prospective borrowers use the standard information regarding the annual percentage rate

to compare various lending products and various lenders and that is a good thing. On the other hand, disclosures are often insufficiently clear and in 1980, Congress rolled back many of the most important and effective provisions of the Truth in Lending Act. It would appear that consumers benefit from fewer and clearer disclosure so that there would be a single easily comparable figure that describes the price a borrower will pay for the financing (Renuart & Thompson, 2008; Sovern, 2010). However, whether this is possible is still an unanswered question. The cohort of borrowers who are most vulnerable to misleading or deceptive products may also be least likely to benefit from financial literacy education or disclosure regimes.

### **Capping Interest and Fee**

There was a time, not so long ago in the USA that the level of consumer debt was significantly less than it is today. One of the reasons was that it was not so profitable for lenders to lend to moderate or higher risk borrowers. It was not so profitable because nearly every state had a limit on the rate of interest that lenders could charge to consumers.

Although most economists continue to resist such restrictions, insisting that the market should be left undisturbed so willing lenders and willing borrowers can make the music they wish to make, findings of behavioral economists that help explain “irrational” self-damaging consumer behavior is creating “chinks” in their armor. We know that some consumers are not acting rationally and in their own best interests and these transactions will cause harm based on that irrational behavior. We also know that harm will have both micro and macroeconomic and sociological negative impacts. On the basis of this knowledge some economists agree that there is sufficient reason to re-impose these materialistic limits on the price lenders may charge for selling their credit. One commentator (White, 2007) suggests that in view of the prevalence of hyperbolic discounters the only way to affect change is to modify the lenders’ conduct. Since the hyperbolic

discounter honestly believes she will pay late and not need bankruptcy, making bankruptcy harder for her will have little effect on her conduct. One suggestion is the French method of prioritizing the sharing of dollars by date of lending so that those who lent in the face of the most debt stand at the back of the line if there is money for the trustee to distribute. Oren Bar-Gill (2004) suggests that credit card teaser rates and premiums be eliminated and Ronald Mann (2006) suggests that creditors raise their minimum monthly payment. Professor Mann has also suggested a “distress” tax on profits of lenders that are earned (Mann, 2006). Mian and Sufi (2015) suggest a new lending instrument that would embrace a risk-sharing provision to protect the borrower in the event of lower house values and give the lender a benefit in the event of higher house values. Perhaps the most popular idea is to require some form of financial underwriting and calibrating amounts lent to ability to repay.

### **Outlawing or Restricting Offensive Practices or Products**

Another way of regulating consumer credit is to identify offending types of transactions and prohibit or heavily regulate those practices. For example, the combination of high interest rates and the practice of “flipping” may cause legislators to outlaw payday lending or restrict flipping. Likewise, legislators might choose to prohibit lending products such as the tax refund anticipation loans or car title lending. The CFPB has begun to investigate whether payday lenders employ practices which should be prohibited (Kirsch et al., 2014). Interestingly, in 2006 as part of the military appropriations legislation, Congress imposed a usury rate of 18 % on payday loans to members of the military which virtually prohibits payday lending. Various states had sought to re-impose interest rate ceilings on payday lending and various other types of loans.

A variation is to identify and prohibit questionable practices such as cross defaulting a credit card to any other consumer obligation, or the right of the lender to change the interest rate at any time.

Teaser rates for credit cards or home mortgages or unlimited number of extensions of payday loans could also be regulated or prohibited. The Credit Card Accountability Responsibility and Disclosure Act of 2009 has partially addressed these issues for credit cards.

Another variation would be to require the lender to make an independent and rational determination that the credit transaction is “suitable” for the borrower. The Fed has listed three factors including suitability and cost and clarity of disclosure for determining if a transaction is predatory and therefore regulated or prohibited. Currently many states are attempting to define “predatory lending” practices and to regulate or prohibit such practices. To some degree the growth of predatory lending has called upon regulators and lawmakers to substitute unconscionability and exemption and limits on enforcement. The first step is to identify the credit transactions we want to outlaw and the basis for that intrusion into the consumer credit market.

### **The Establishment of the CFPB**

When the CFPB celebrated its fourth birthday in July, 2014, it had moved to identify and curb abuses in the areas of credit cards, mortgages, student loans, credit reports, debt collection, abusive payday lending, and foreign money exchanges. Among the most interesting are the efforts to require that lenders make a good faith determination that the borrower has a likelihood of repaying the credit extension.

### **Bankruptcy Fresh Start as a Consumer Protection Device**

The consumer bankruptcy law and system are integral parts of the consumer financial protection landscape. Key policy issues involved in setting the parameters for bankruptcy relief are (1) the cost of the discharge, who is eligible, and to what extent must they pay a share of their future wages to obtain the discharge; and (2) to what extent should the bankruptcy discharge affect

those creditors that have liens that are valid outside bankruptcy. This topic is treated in Chap. 26 of this book.

---

### **Conclusion**

Will the system of consumer borrowing and lending in the USA work satisfactorily as the ghost of the crash becomes more distant, and if not, what might be done to improve the way the consumer lending and borrowing system works? Once the trauma of the crash has receded it is likely that the mixed State and Federal “system” will once again encourage consumers to borrow and spend and encourage lenders to lend so that consumers, lenders, and the economy may prosper. Some consumers use the borrowed money to improve their lives; others are burdened with the various kinds of distress and shattered dreams that accompany hopelessly high debt. Lenders seem to be able to lend profitably in the current environment and are unlikely to reduce such lending unless it is outlawed or becomes less profitable. Because even the most sophisticated credit-scoring devices have limitations, likely practice and policy guarantee large numbers of defaults, large numbers of people going to credit counseling, large numbers of foreclosures, and large numbers of bankruptcies. This tendency will be accelerated by the growing and uncontrolled inequality of income and net worth. This is the clear and currently inevitable effect of the consumer lending revolution. The profitability of all lending, but particularly subprime lending, provides an attractive investment opportunity and therefore there will be no shortage of dollars to lend on the subprime market. Is there any way to stop the kinds of frenzy that existed in 1929 and in 2007 without reducing “productive” lending?

Crafting effective policy and legislation is further complicated by the fact that those who pay late are among the most profitable individual customers; if lenders tighten their lending standards or if consumers reduce their borrowing, then financial institution profitability will fall and attract less capital, consumer spending will be reduced, and the economy will be less vigorous.

In the current political climate, it is extremely unlikely that income support programs (other than the Earned Income Credit) will be enacted or that the extraordinary inequality of income or wealth will otherwise be reduced. There are, however, a number of steps that seem possible and may accomplish these more limited goals. The early actions of the CFPB and the impact of the 2009 credit card law have combined with the trauma of the crash to cause a reduction in several kinds of borrowing and lending and securitization investing. However, once the trauma recedes it will be essential for the CFPB to continue and intensify its efforts. For example, they should take such action as is necessary and the Congress and State Legislatures and the Federal Reserve Board should take such action as is necessary to accomplish the following:

1. Establish a suitability standard that places a burden on the lender to make any consumer credit lending only when it is the suitable product and has a reasonable chance of being repaid.
2. Regulate subprime lending in order to establish an upper limit on the cost of credit and restrictions or prohibitions on the most nefarious lending products and practices. Perhaps we could use the criteria established by the Federal Reserve Bank, that the presence of very high pricing, lack of clarity, and failure to maintain reasonable underwriting standards as standards for defining predatory or regulable or prohibited conduct. We should carefully watch states, such as North Carolina, that are leading the way in this field.
3. Reestablish usury rates for interest and fees.
4. Provide a reasonable floor on exemptions.
5. Implement and evaluate kindergarten through college and adult financial literacy programs, as well as savings incentive programs such as the individual development account.
6. Experiment with behavior change courses and counseling for those whose path to over indebtedness involved conduct susceptible to such counseling.
7. In light of the mass of home foreclosures caused by the subprime mortgage crisis, with regard to which the current bankruptcy law is of no help, amend the Bankruptcy Code to help forestall the tragedy caused by such massive foreclosures.
8. Use a standard of abusiveness to regulate payday lending and encourage the use of installment payments and a requirement of ability-to-pay.
9. Other methods of altering the conduct of the lenders would include (a) the French method of prioritizing the sharing of dollars by date of lending so that those who lent in the face of the most debt stand at the back of the line if there is money for the trustee to distribute; (b) Oren Bar-Gill's (2004) suggestion that credit card teaser rates and premiums be eliminated; (c) Ronald Mann's (2006) suggestion that creditors raise their minimum monthly payment and impose a "distress" tax on profits of lenders that are earned; and (d) Create a new consumer lending instrument that calls for the sharing of benefit and harm when unanticipated events occur (Mian & Sufi, 2015).

The CFPB has begun to fashion new and creative protective vehicles and to breathe new life into others that had atrophied. This trial and error method is a step on the right track.

#### About the Author

**David Lander, J.D.**, is a Professor of Practice at Saint Louis University Law School. He received his B.A. from Bowdoin College and his J.D. from the University of Chicago Law School. He is a member of the National Bankruptcy Conference and the American College of Bankruptcy. He is the author of a number of articles on the consumer credit counseling industry and other bankruptcy and consumer credit issues.

---

#### References

- Angeletos, G., Laibson, D., Repetto, A., Tobacman, J., & Weigberg, S. (2001). The hyperbolic consumption model: Calibration, simulation and empirical evaluation. *Journal of Economic Perspectives*, 15(3), 47–68.
- Bar-Gill, O. (2004). Seduction by plastic. *Northwestern University Law Review*, 98(4), 1373–1434.

- Bar-Gill, O., & Warren, E. (2008). Making credit safer. *University of Pennsylvania Law Review*, 157, 1–101.
- Brady, P. J., Canner, G., & Maki, D. M. (2002). The effects of recent mortgage refinancing. *Federal Reserve Bulletin*, 86(July), 441–450.
- Bricker, J., Dettling, L. J., Henriques, A., Hsu, J.W., Moore, K. B., Sabelhaus, J., et al. (2014). Changes in U.S. family finances from 2010 to 2013: Evidence from the Survey of Consumer Finances. *Federal Reserve Bulletin*, 100(4), 1–40.
- Bricker, J., Kennickell, A. B., Moore, K. B., Sabelhaus, J. (2012). Changes in U.S. family finances from 2007 to 2010: Evidence from the Survey of Consumer Finances. *Federal Reserve Bulletin*, 98(2), 1–80.
- Burhouse, S. (2003). Evaluating the consumer lending revolution. *FYI: An Update on Emerging Issues*. Retrieved March 15, 2007, from <http://www.fdic.gov/bank/analytical/fyi/2003/091703fyi.html>
- Caldor, L. (1999). *Financing the American dream*. Princeton, NJ: Princeton University Press.
- Campbell, J., Jackson, H., Madrian, B., & Tufano, P. (2011). Consumer financial protection. *Journal of Economic Perspective*, 25(1), 91–114.
- Canner, G., Dynan, K., & Passmore, W. (2002). Mortgage refinancing in 2001 and early 2002. *Federal Reserve Bulletin*, 88(December), 469–481.
- Center for Responsible Lending Website (2014). <http://www.responsiblelending.org/>
- Chomsisengphet, S., & Pennington-Cross, A. (2006). The evolution of the subprime mortgage market. *Federal Reserve Bank of St. Louis Review*, 88(1), 31–92.
- Collins, J. M. (2013). The impacts of mandatory financial education: Evidence from a randomized field study. *Journal of Economic Behavior & Organization*, 95, 146–158.
- Da Casta, P. N. (2014, August 26). Bernanke: 2008 meltdown was worse than great depression. *Wall Street Journal*. Retrieved <http://blogs.wsj.com/economics/2014/08/26/2008-meltdown-was-worse-than-great-depression-bernanke-says/>
- Ellis, D. (1998). The effect of consumer interest rate deregulation on credit card volumes, charge-offs, and the personal bankruptcy rate, *Bank Trends*, (98-05), 1–11.
- FDIC. (2003). *Evaluating the consumer lending revolution*. Washington, DC: Author. Retrieved from <https://www.fdic.gov/bank/analytical/fyi/2003/091703fyi.html>.
- Federal Reserve Bank of New York. (n.d.). Household credit. Retrieved from <http://www.newyorkfed.org/regional/householdcredit.html>
- Hyman, L. (2011). *Debtor nation: The history of America in red ink*. Princeton, NJ: Princeton University Press.
- Kirsch, L., Mayer, R. N., & Silber, N. I. (2014). The CFPB and payday lending: New agency/old problem. *Journal of Consumer Affairs*, 48(1), 1–16.
- Klywev, V., & Mills, P.(2006). Is housing wealth an ATM? The relationship between housing wealth, home equity withdrawal and savings rates. *IMF Working Paper 2006*.
- Krainer, J., & Marquis, M. (2003). Mortgage refinancing. *FRBSF Economic Letter*, 2003-29, 1–3.
- Lea, S. E., Webley, P., & Levine, R. M. (1993). The economic psychology of consumer debt. *Journal of Economic Psychology*, 14(1), 85–119.
- Levenger, B., & Zabek, M. A. (2011). Debit or Credit. Communities in Banking 2011. In G. M. Breakwell (Ed.), *The social psychology of political and economic cognition* (pp. 161–183). London: Surrey University Press.
- Maki, D. M., & Michael G. P. (2001). Disentangling the wealth effect: A cohort analysis of household saving in the 1990s. *Finance and Economics Discussion Series 2001–21*, Board of Governors of the Federal Reserve System. Retrieved from <http://www.federalreserve.gov/pubs/feds/>
- Mann, R. (2006). *Charging ahead: The growth and regulation of payment card markets around the world*. Cambridge: Cambridge University Press.
- Mann, R. J. (2013). *Assessing the optimism of payday loan borrowers*. Columbia Law and Economics Working Paper, (443).
- Manning, R. D. (2000). *Credit card nation: The consequences of America's addiction to credit*. New York: Basic Books.
- Martin, N., & Sweet, T. (2006). Mind games: Rethinking BAPCPA's debtor education provisions. *Southern Illinois University Law Journal*, 31, 517–547.
- McConnell, M. M., Peach, R. W., & Al-Haschim, A. (2003). After the refinancing boom: Will consumers scale back their spending? *Current Issues in Economics and Finance*, 9(12), 1–7.
- Mian, A., & Sufi, A. (2015). *House of debt: How they (and you) caused the great recession, and how we can prevent it from happening again*. Chicago: University of Chicago Press.
- Montezemolo, S. (2013). *Payday lending abuses and predatory practices*. Durham, NC: Center for Responsible Lending. Retrieved from <http://www.responsiblelender.org/state-of-lending/reports/10-Payday-Loans.pdf>.
- Pacelle, M. (2004, July 6). Growing profit source for banks: Fees from riskiest card holders, late payers and big borrowers are becoming cash cows. *Wall Street Journal*, Retrieved <http://www.WSJ.com>
- Renuart, E., & Thompson, D. (2008). The truth, the whole truth, and nothing but the truth: Fulfilling the promise of truth in lending. *Yale Journal on Regulation*, 25(181), 230–231.
- Ritzer, G. (1995). *Expressing America: A critique of the global credit card society*. Thousand Oaks, CA: Pine Forge Press.
- Schor, J. B. (1998). *The overspent American: Why we want what we don't need*. New York: Basic Books.
- Shen, S., Abdoul, G., Sam, A. G., & Jones, E. (2014). Credit card indebtedness and psychological well-being over time: Empirical evidence from a household survey. *Journal of Consumer Affairs*, 48(3), 431–456. (<http://www.FT.com>)

- Sovern, J. (2010). Preventing future economic crises through consumer protection law or how the truth in lending act failed the subprime borrowers. *Ohio State Law Journal*, 71(4), 761–844.
- Wallace, G. (1976). The uses of low rate ceilings reexamined. *Boston University Law Review*, 56(3), 451–497.
- Warren, E., & Tyagi, A. (2003). *The two-income trap: Why middle class mothers and fathers are going broke*. New York: Basic Books.
- White, M. (2007). *Bankruptcy reform and credit cards* (NBER Working Series Paper 13265). Retrieved from <http://www.nber.org/papers/w13265>
- Willis, L. (2008). Against financial literacy. *Iowa Law Review*, 94(08–10), 197–285.
- Xiao, J. J., & Yao, R. (2014). Consumer debt delinquency by family lifecycle categories. *International Journal of Bank Marketing*, 32(1), 43–59.