Berkeley Law | Center for Consumer Law & Economic Justice

Rohit Chopra
Director
Consumer Financial Protection Bureau
1700 G Street, NW
Washington, D.C. 20552

VIA E-MAIL

February 17, 2022

Dear Director Chopra:

We are pleased to share with you and your colleagues the product of a recent discussion of emerging issues in the area of consumer financial protection. Participants in the project include a diverse collection of legal scholars motivated by a shared concern: the regulatory challenges posed by an increasingly complex financial products marketplace in which consumers confront ever more sophisticated forms of credit and other transactions, and in which vendors operate with the benefit of vast amounts of information about potential customers.

The project produced a set of brief memoranda, which are attached to this e-mail message and also available on the website of **Berkeley Law's Center for Consumer Law & Economic Justice.** Each memorandum briefly identifies a potential concern; a proposed research agenda to ascertain the nature, scope, and likelihood of the risk posed to consumers; and a potential regulatory response.

The memoranda address a variety of topics, summarized below in bullet format.

- **Preventing harmful algorithmic discrimination**. Lenders are increasingly using big data and sophisticated algorithms to guide product design, targeting and pricing. Because this practice might result in price and quality discrimination against vulnerable borrowers, it should be tracked and studied and, potentially, regulated. (Oren Bar-Gill)
- **Reining in mandatory arbitration clauses**. Congressional disapproval of the Arbitration Rule under the Congressional Review Act is an opportunity for the Bureau to adopt a broader, more effective rule preserving consumer choice in dispute arbitration that would likely survive judicial review and not require substantial new data collection. (Prentiss Cox)
- **Discrimination in "income share agreements."** Having designated income share agreements, marketed as an alternative to student loans, as a credit product, the Bureau should now assess the possibility and prevalence of violations of the Equal Credit Opportunity Act in this area. (Kate Sablosky Elengold)
- **Detecting credit discrimination**. Ascertaining increasingly sophisticated lending discrimination may require adoption of "matched-pair testing" by the Bureau, with methods that do not run afoul of laws prohibiting the submission of false financial information. (Kathleen C. Engel)
- **Credit scoring practices and discrimination**. As alternative credit scoring gains traction, the Bureau should track and analyze these scoring models, with an eye toward issuing guidance and

rulemaking aimed at ensuring that alternative methods do not worsen, overall, disparities in access to important products, services, and opportunities. (Pamela Foohey)

- **Credit marketed as something other than credit**. As more companies market credit products characterized as something other than credit products – such as "income share agreements" in higher education, "home equity investments" in real estate, and "training repayment agreements" in employment – the Bureau should consider enforcement and rulemaking to establish that existing laws in fact apply to these products. (Jonathan D. Glater)
- **Refining competition and prioritizing fairness**. The Bureau's overarching objective should be to promote fair treatment rather than "competition," and it should closely consider under which circumstances competition in its various forms promotes that goal. (Luke Herrine)
- **Detecting and preventing discrimination in debt collection.** When borrowers are unable to repay their obligations, lenders and servicers may act unequally along racial lines in attempting to work out a resolution. These practices violate the Equal Credit Opportunity Act and in many cases should be considered "unfair" under the Consumer Financial Protection Act. (Dalié Jiménez)
- **Preventing discrimination in advertising**. Providers of high-cost credit target communities of color through false and misleading advertising, which the Bureau should address through rulemaking restricting certain advertising practices and requiring disclosure of the impact of loan terms. (Creola Johnson)
- **Adopting disparate impact analysis under Regulation B**. Because lenders increasingly use artificial intelligence in underwriting and may not know which applicant characteristics affect loan availability or terms, the Bureau should promulgate a rule under Reg B that explicitly adopts a "disparate impact" standard for liability, sets forth an analytical framework for determining when disparate impact produces liability, and specifically addresses the particular complications AI presents for disparate impact analysis. (Adam Levitin)
- **Establishing oversight of credit card issuers in the "buy now, pay later" market.** The entry of credit card issuers into the BNPL market has the potential to blur the line between installment and revolving credit, leaving consumers confused and paying more than they expect. In addition, competition from credit card issuers could cause BNPL apps to modify their pricing in the direction of less transparency. The Bureau needs to monitor, research, and potentially respond to the impact of this change in the market. (Angela Littwin)
- **Analyzing new mortgage lending rules and technologies for inadvertent discriminatory effect**. Recent technological developments and deregulatory steps by prior CFPB administrations may inadvertently be causing lenders and mortgage servicers (1) to engage in algorithmic discrimination that systematically harms borrowers of color, (2) to steer minority customers to higher-cost loan products, and (3) to engage in servicing practices that systematically disfavor borrowers of color. The Bureau should analyze and, if necessary, redress any discriminatory effects. (Patricia A. McCoy)
- **Assessing substitution and other effects of regulation**. Because borrowers switch between and supplement different types of credit, the Bureau must monitor how restricting or modifying access to one type of loan may affect consumer use of other forms of credit with comparable or worse effects. (Paige Marta Skiba)
- **Improving the efficacy of disclosures**. Since different forms of disclosure affect consumer behavior to a greater or lesser degree, the Bureau should study and then mandate those forms (such as single letter grades) that best protect consumers. (Jeff Sovern)
- **Analyzing the use and impact of overdraft protection**. Given the imminent abandonment of overdraft fees by several banks, this is an opportune time to assess consumer financial health with and without access to overdraft. Lessons learned from overdraft research also could inform policymaking regarding nontransparent pricing generally. (Lauren Willis)

We hope that these memoranda are useful and help to inform ongoing conversations between the Bureau and the legal academy. The individual authors would be happy to discuss their analysis further with you or others at the Bureau or sister agencies, if that would be helpful.

Thank you for your consideration.

Sincerely,

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Algorithmic Discrimination

Oren Bar-Gill[1*]

Executive Summary

Lenders are increasingly using big data and sophisticated algorithms to guide product design, targeting and pricing. This might result in price and quality discrimination that hurt vulnerable borrowers. Algorithmic discrimination should be tracked and studied and, potentially, regulated.

Problem

While lenders have always sought to tailor loan terms to a borrower's profile, the increasing utilization of big data and sophisticated algorithms is taking such tailoring, or discrimination, to a new level. Certain manifestations of discrimination are efficient. For example, there is good reason to tailor the interest rate to the individual borrower's default risk. However, there are also reasons to be concerned about the risk of algorithmic discrimination. This short memorandum briefly describes two scenarios where discrimination can be harmful to borrowers and thus potentially merit regulatory attention.

First, consider algorithmic *price* discrimination.[2] While algorithms can be efficiently used to predict default risk, they might also be harmfully used to predict the borrower's willingness to pay (WTP), i.e., how much money can be extracted from the borrower in interest, fees and penalties. Such price discrimination can eliminate much of the consumer surplus in the credit market. The problem is further exacerbated, when the WTP that is tracked by the algorithm is influenced by borrower misperceptions. There is much evidence that misperceptions influence WTP; and there is every reason to believe that algorithms track such misperception-infused WTP. A borrower might be willing to pay a higher interest rate, because she overestimates the benefit from the loan. For example, the borrower might be willing to take-out an expensive mortgage, because she mistakenly thinks that the market prices of real-estate will continue to climb at double-digit rates. Or a borrower might be willing to pay a higher interest rate, because she mistakenly underestimates her ability to obtain better terms from another lender. The algorithm will learn to identify borrowers with higher WTP and charge them higher prices.

When WTP is fueled by misperception, algorithmic price discrimination not only reduces borrowers' benefits from credit, it affirmatively harms borrowers. Moreover, such algorithmic price discrimination reduces overall welfare in the consumer credit market (in addition to reducing the consumer surplus, to negative levels). Specifically, if the borrower is willing to pay a higher interest rate because she overestimates the benefit from the loan, the borrower might suffer a net loss from the transaction (i.e., pay more than the loan is actually worth to her). This is obviously harmful to the borrower. And it also implies that inefficient loans—loans where the cost to the lender exceeds the benefit to the borrower—will be originated. And if the borrower is willing to pay a higher interest rate because she mistakenly underestimates her ability to obtain better terms from another lender, algorithmic price discrimination will deprive this borrower from the benefits of competition. In essence, lenders will compete only over borrowers who shop around and not compete at all over borrowers who (mistakenly) decide not to shop for better terms. (If lenders cannot discriminate based on a borrower's perceived likelihood of getting better terms elsewhere, these mistaken borrowers will benefit from the comparison shopping done by other borrowers.)

[1*] William J. Friedman and Alicia Townsend Friedman Professor of Law and Economics, Harvard Law School.

[2] The following discussion of algorithmic price discrimination extends the analysis in: Oren Bar-Gill, Algorithmic Price Discrimination: When Demand is a Function of Both Preferences and (Mis)perceptions, 86 U. Chi. L. Rev. 217 (2019).

Second, consider algorithmic *quality* discrimination. Here, the algorithm matches different borrowers with different product designs. For example, one design of a credit card product may include a single price dimension—an interest rate, whereas another design may include, in addition to the interest rate, multiple back-end fees and penalties. Using the algorithm, a lender might offer the simple, one-price card to more sophisticated borrowers and the complex card with the back-end fees to less sophisticated borrowers who underestimate the likelihood of triggering those back-end fees. (Note that, while the product design includes pricing elements, this scenario is different from the previous, price discrimination scenario, where the product design was held fixed and the *level* of the interest or fee varied from one borrower to the next.)

The welfare implications of algorithmic quality discrimination are subtle. Specifically, they depend on what lenders would do in a pre-algorithmic world where they cannot distinguish between the more- v. less-sophisticated borrowers and thus offer the same product design to all borrowers. If, in this pre-algorithmic world, lenders would offer the simple, one-price card to all borrowers, then algorithmic discrimination harms borrowers. In particular, it harms the more vulnerable, less sophisticated borrowers. It is possible, however, that if lenders cannot discriminate, they would offer the complex card with the back-end fees to all borrowers. In this case, algorithmic discrimination may help some borrowers.[3]

Recommendations

The Consumer Financial Protection Bureau is rightly interested in studying the implications of big data and algorithms in the consumer credit space. This short memorandum provided two preliminary directions in which the Bureau can take this study. Pragmatically, the memo helps to identify consumer credit markets where algorithms can be harmful to borrowers. In particular, if the Bureau observes increased levels of price discrimination, triggered by the use of algorithms, this should merit further investigation, especially if the Bureau believes that the enhanced price discrimination is driven my borrower misperceptions (rather than by more accurate, or more tailored, cost/risk predictions). In addition, if the Bureau observes an increase in the number of products (or product designs) in a certain consumer credit market, triggered by the use of algorithms, this should also merit further investigation, especially if the new product designs exhibit greater complexity, less transparent pricing or other potentially harmful features.

[3] There is another possibility: If lenders cannot discriminate, they might offer a third product design (i.e., not one of the two product designs described in the text). In this case, algorithmic discrimination might help some borrowers while harming others.

Ban Pre-Dispute Arbitration Contracts

Prentiss Cox

Executive Summary

Congressional disapproval of the CFPB Arbitration Rule under the Congress Review Act is an opportunity for the Bureau to adopt a broader, more effective rule preserving consumer choice in dispute arbitration that would likely survive judicial review and not require substantial new data collection.

Problem

Summary of Issue

Consumer scholars and advocates understand the abuses that flow from consumer arbitration clauses in boilerplate contracts. Consumers lose fundamental rights—to a jury, to appeal of decisions of law (or even an explanation of legal decisions), to a decision-maker not selected by the seller, etc.

In promulgating its 2017 arbitration rule, the CFPB made a fundamental error in its conceptualization of the problem. Rather than focusing on a remedy for the imbalance in market power at the time of contract origination that unfairly deprives consumers of choice when disputes arise, the Bureau primarily studied whether judicial lawsuits produce better outcomes than arbitrations. Rather than emphasize its finding "that consumers rarely affirmatively and knowingly elect to enter into pre-dispute arbitration agreements," the Bureau focused on whether class actions produce net consumer benefits. The result was that the Bureau spent more than five years studying and writing a lengthy, limited rule grounded in a narrow economic analysis that would likely have had no better chance of surviving judicial review than a concise rule that would fully protect consumer choice when a dispute arises.

The CFPB Arbitration Study and Rule

The Dodd Frank Act (DFA) mandated that the Bureau conduct a study of arbitration prior to promulgating a rule. The Bureau published its Arbitration Study (the Study) in March 2015, approximately three years after issuing an RFI. The bulk of the Study, in chapters 5 to 9, compared the outcomes of arbitrations to other forms of law enforcement, including small claims court, public enforcement and class action cases. The Study was a rousing defense of the value of class actions for providing consumer relief and, to a lesser extent, for reforming market conduct.

The Bureau published a proposed rule in May 2015, and the final rule was issued in July 2017. The key provision, section 1040.4(a), prohibited class action waivers in arbitration clauses and required the inclusion of express provisions in arbitration contract clauses about the right to participate in class actions. The primary justification for the rule was that class actions were needed because of the infrequency of individual suits and the effectiveness of class cases in obtaining consumer relief that would not have occurred through public enforcement. The Bureau concluded that "because of these outcomes, allowing consumers to seek class action relief was consistent with the Study..."

The Congressional Review Act

Congress overturned the Rule under the CRA in November 2017. Only twenty federal rules have been overturned by Congress under the CRA, with sixteen of those actions occurring in the first year of the Trump Administration. Congressional disapproval of the Arbitration Rule in 2017 places obstacles in the path of any new arbitration rule that the Bureau might promulgate. An agency may not promulgate a "new rule that is substantially the same." 5 U.S.C. § 801(b)(2).

No case law exists on the interpretation of "substantially the same" under the CRA. Two rules have been re-promulgated following Congressional disapproval. These two rules, issued by the DOL and the SEC following Congressional disapproval in 2017, have been described by the Congressional Research Service as follows: "Both agencies sought to determine the 'central' issue at the heart of the disapproved rule and concluded that they had to change that aspect of the rule rather than change solely their original justifications or more ancillary provisions."[4]

Recommendations

<u>Regulatory Action</u>. The Bureau misconceived the problem with arbitration by focusing on dispute-resolution results rather than the imbalance of market power at contract origination. The Rule did not prohibit pre-dispute arbitration because the Bureau decided that data on outcomes in individual arbitrations compared to judicial litigation outcomes was "inconclusive." The fundamental error here was that nothing prevents consumers from deciding to arbitrate at the time a dispute arises, but pre-dispute arbitration contracts deprive consumers of the right to make that choice. The Bureau focused on the wrong end of the deal.

A new rule banning pre-dispute arbitration clauses follows from re-orienting the consumer protection question to consumer understanding of the consequences of arbitration agreements at the time of contract origination. This new arbitration rule would be supportable without extensive new research because the information needed to draft and support such a rule substantially exists in the parts of the Study from 2015 that the Bureau largely ignored in designing and justifying its Arbitration Rule. Chapter 2 of the Study establishes that arbitration clauses are "contracts of adhesion offered on a take-it-or-leave-it basis." Most importantly, Chapter 3 used multiple methodologies to show that an overwhelming majority of consumers do not knowingly waive their fundamental rights to access our courts. And Chapter 10 of the Study would remain relevant in establishing that arbitration provides no overall price benefit to consumers. This is the core information needed to re-write the Rule.

The new arbitration rule also would be easy and less costly to implement, and easy for the public to understand. The Bureau has repeatedly approached rulemaking by spending an inordinate amount of time and energy on every possible challenge to a prospective rule, and then developing complex, clever, nuanced solutions to fill every rathole of possible opposition. The problem with pre-dispute arbitration clauses is not complex; it is the result of a massive power imbalance in contract formation that deprives consumers of choice when disputes later arise. The solution is not complex; move the point of consumer decision about the best forum for dispute resolution from contract formation to the time when the dispute arises.

<u>Research Questions</u>

1. *Is there additional information on consumer understanding of arbitration agreements available since the Study was released in 2015*? *Are there any gaps in the current record on consumer understanding that need additional study*?

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[4] Section 805 of the CRA limits judicial review of decisions under the Act, and courts have held that some agency actions are not reviewable under the CRA. No court has opined on the reviewability of an agency re-promulgation of a disapproved rule, and this outline assumes judicial review under the CRA is available on the issue of whether a new rule is "substantially the same" as a disapproved rule.

2. *How would a focus on preserving consumer choice in dispute resolution make the new rule not "substantially the same" as the prior rule*? *What is the most accurate characterization of the Congressional record underlying the CRA action*? *Would a focus on preserving dispute resolution choices address these concerns*?
The primary concern expressed in the CRA proceedings appears to be that arbitrations produce better outcomes for consumers than lawsuits, and the (incorrect) assertion that the Bureau Study supported this conclusion.

3. *What additional benefits can be discerned from preventing consumer deprivation of dispute resolution choices*? *How do pre-dispute arbitration clauses impact consumer choice at the time disputes arise?*
At minimum, a rule preserving consumer rights in dispute resolution would increase the choices available to consumers in individual disputes. Most consumers do not make a choice to be in a class action, other than when presented with an opt-out notice.

4. *What would be the impact on costs imposed by a rule to preserve consumer choice in dispute resolution compared to the prior rule*?
The prior rule included a "monitoring" provision that required companies to report to the Bureau data on their use of arbitration. It also required rewriting arbitration contracts to include prescribed language on class action rights. Neither companies nor the Bureau would incur these costs under a re-focused rule. In fact, marginal enforcement and compliance costs should be almost nothing.

5. *What are the options for how to structure a rule to protect consumer choices in dispute resolution*?
The simple, effective solution would be to ban pre-dispute arbitration clauses in contracts. Other alternatives that could be analyzed are to attack the boilerplate problem by requiring indicia of effective consent or preserving access to courts regardless of the existence of arbitration contract clauses.

Income Share Agreements and the Risk of Discrimination

Kate Sablosky Elengold

Executive Summary

In light of the ever-increasing cost of a college education and the increasing attention to the inequities built into America's student loan scheme, both students and institutions are looking for alternative mechanisms to fund higher education. One alternative—income share agreements or "ISAs"—is thus growing in popularity, availability, and scope. The Bureau has already taken the critical step of asserting that ISAs, informally billed as loan alternatives, are, in fact, loans. Now, regulatory and enforcement agencies must consider if and how the nature of ISAs may lead to discriminatory conduct and effect.

Problem

Income-share agreements are contracts. They vary widely, with respect to the terms of the agreement, the funding source, accessibility, and mechanisms for challenge. The terms of the ISA, including the percentage of the student's income share for repayment, differ across schools and contracts. Although terms are often based on the student's major or concentration, the reputation of the student's school, and/or the student's expected earning potential, lack of transparency makes it difficult to understand exactly what is considered in individual ISA terms.

ISAs may be funded by higher education institutions, donations, investors, or some combination of the three. Regardless of the funding structure, however, many programs contract with for-profit ISA facilitators like Vemo Education to implement and oversee the ISA. Like for-profit student loan funders and/or servicers, introducing a profit motive into an educational space skews incentives and prioritizes dollars over students.

As income-share agreements grow in popularity, profit motives are likely to reshape the terms and scope of the agreements. Already, investors are interested in income-share agreements as a mechanism to make money, rather than as a mechanism to increase access to college education.

Although ISAs may serve an important role in the higher education financing market, because ISA terms are set based on a student's perceived future earning potential, it is critical to consider whether and how the nature of ISAs could disadvantage certain students. The structures of higher education and the labor market will operate to raise the rates (through less advantageous repayment terms) for students of color, women, and other marginalized populations. This is due, at least in part, to lesser opportunity and discrimination in the job market; disproportionate attendance at for-profit colleges and universities and other lower-prestige schools; disproportionate attendance at HBCUs and HSIs; and disproportionate entrance into lower-paying fields.

Although there is little empirical research on who is targeted for and using ISAs, limited reporting and research has shown that ISAs have been (or could easily be) targeted to historically marginalized students.

- ISAs are appealing to those who are traditionally debt averse. Research has shown that Latino students are more debt averse relative to their non-Latino peers.[5]

[5] Elengold et al., *Debt, Doubt, and Dreams: Understanding the Latino College Completion Gap*, https://law.unc.edu/wp-content/uploads/2020/11/Debt-Doubt-and-Dreams-Report.pdf

- Certain Islamic and Russian Orthodox students may be drawn to ISAs because of a religious prohibition on paying interest.[6]
- A study of Stride Funding ISAs showed that students at HBCUs were charged more in repayment than the students at primarily white institutions.[7]
- Inclusion of binding arbitration clauses and class-action bans in ISA contracts make it more difficult for litigation to bring to light concerns about ISA equity.[8]
- Certain ISAs have been targeted to DREAMers and others ineligible for federal student aid.[9]

To adequately deal with this problem, regulators need a three-step process: (1) data collection, (2) ECOA rulemaking, and (3) ECOA enforcement.

Recommendations

Research. Research must be specifically focused on the intersection of ISAs and lending discrimination, specifically ECOA. Empirical research should undertake to explore (1) student interest level in ISAs as relative to traditional public and private student loans, broken down by ECOA protected classes; (2) differences in how ISAs are marketed and implemented, broken down by the kind of entity funding the ISA; (3) whether and how ISAs are targeted to specific groups of students, broken down by ECOA protected classes and the kind of entity funding the ISA; (4) the demographics of the students who enter into ISAs, broken down by ECOA protected classes and the kind of entity funding the ISA; and (5) the metrics for repayment of existing ISAs, including how much has been paid over what period of time, broken down by ECOA protected classes and the kind of entity funding the ISA.

Rulemaking. The Bureau should consider an ECOA rulemaking that sets out the option and process for proving disparate impact under the statute.

Enforcement. The Bureau should use its enforcement powers to challenge ISA providers that run afoul of ECOA. By using its enforcement authority swiftly and decisively, the Bureau will make a public statement to those who are in the ISA space or who are seeking to enter the ISA space that regulators are paying careful attention to the effects of these products on protected populations.

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[6] Robert Farrington, *Income Share Agreements Are Growing in Popularity To Pay For School*, FORBES (June 28, 2021, 10:20 AM), https://www.forbes.com/sites/robertfarrington/2021/06/28/income-share-agreements-are-growing-in-popularity-to-pay-for-school/?sh=44066117508e.

[7] Inequitable Student Aid, STUDENT BORROWER PROTECTION CENTER (March 2021), https://protectborrowers.org/wp-content/uploads/2021/03/SBPC_Inequitable-Student-Aid.pdf

[8] *See* Letter from Senator Elizabeth Warren, Representative Ayanna Pressley, and Representative Katie Porter to Secretary Betsy DeVos (June 4, 2019), https://www.warren.senate.gov/imo/media/doc/Letter%20to%20DeVos%20re%20ISAs.pdf

[9] *Fund Sueños: Today For Me, Tomorrow For You*, COLORADO MOUNTAIN COLL., https://coloradomtn.edu/suenos/.

Maximizing the Ability to Test for Credit Discrimination

Kathleen C. Engel

Executive Summary

There is substantial evidence that credit discrimination persists, yet private plaintiffs and public enforcers bring few claims. Advocates have identified a number of factors that contribute to the paucity of claims. There is one factor, however, that has received little attention: testing for credit discrimination is nearly impossible because of federal laws that prohibit the filing of false financial statements when applying for federal loans or federally-backed loans. One option would be for the Bureau to create standardized consumers for matched-pair testing, relying on models used in law enforcement to create fictional identities.

Problem

Many obstacles limit the pursuit of fair lending claims. From the perspective of applicants for credit, it is difficult to learn they have been denied credit, charged more, or steered to less desirable products because of their race or other protected class status.

Even when people have reason to believe that lenders have discriminated against them, private attorneys are often reluctant to take on individual credit discrimination claims because of low damage awards and the significant amount of discovery the cases can entail. In addition, credit discrimination claims often require deep knowledge of multiple and complex loan terms and products, skills that not all consumer attorneys have.

Furthermore, depending on the jurisdiction, when discrimination cases settle, the plaintiffs' attorneys typically do not recover their fees under fee-shifting statutes and, instead, receive one-third of the settlement amount. One-third of a small amount is typically insufficient to cover the cost of litigating a credit discrimination case.

Class action credit discrimination cases, which can generate substantial attorney's fees, have significant up-front costs that smaller firms may not be able to afford. More importantly, unless there is a facially discriminatory action, policy or practice, plaintiffs' attorneys may not be able to identify the mechanism of discrimination—whether it is intentional or disparate impact-- with enough specificity to overcome a motion dismiss.

State enforcers face fewer challenges, in part because they can issue civil investigative demands (CIDs), which give them an early read on the strength of any claims they are considering. Information obtained through CIDs can also help them identify the intentional discrimination or the practice that has a disparate impact. Just the same, public enforcement of credit discrimination laws proceed only if leaders of the relevant agencies prioritize bringing such claims and commit funds to cover extensive expert work to analyze data and help develop cases.

The CFPB has an obligation to enforce laws prohibiting credit discrimination and is in the best position to bring discrimination claims. When there is no "smoking gun" evidence, the Bureau typically relies on analyzing data to determine whether a pattern of discrimination exists at a financial institution. This is a cumbersome, expensive, and time-consuming task. Relying solely on statistical evidence has problems, too. This is because some statistical techniques can lead to flawed conclusions.

Matched-pair testing, which is a type of audit study, has the potential to solve some of the challenges to detecting credit discrimination and enforcing the law. With matched-pair testing, multiple pairs of people separately seek credit from the same institution. Each pair is virtually identical except for the feature being tested, e.g. race. Each pair has a set script and is trained to give the same responses to anticipated questions. Their experiences are compared to see if each pair was treated the same or differently.(This is a very pared down description of matched-pair testing).

Matched-pair testing has the potential to reveal discrimination early on and inexpensively. Depending on the strength of the testing results, it can even obviate the Bureau's need to obtain and evaluate data before filing a complaint. Furthermore, matched-pair testing can be a powerful investigative tool when examining institutions that interact directly with consumers and could also be used to estimate the extent of discrimination in the financial marketplace.

In the context of housing discrimination cases, plaintiffs have long used matched-pair testing of homeowners or real estate professionals to determine whether they were denying rental units or refusing to sell homes to people based on their protected class status.

The challenge with implementing matched-pair testing for credit discrimination is that it is a federal crime to submit false financial information when applying for a federal loan or a federally-backed loan (sec. 18 U.S.C. 1014). Thus, testing has been limited to situations in which testers are exploring credit options without any review of their credit histories. For example, M & T Bank settled with customers whose loan officers steered them to neighborhoods and loan products based on their race. Testing revealed that the bank treated white people and people of color differently when suggesting products (https://www.housingwire.com/articles/34956-mt-bank-reaches-settlement-over-discriminatory-lending-charges/). Similarly, CFPB used matched-pair testing in a case against BanCorpSouth, alleging that loan officers treated customers differently based on their race (https://www.justice.gov/opa/pr/justice-department-and-consumer-financial-protection-bureau-reach-settlement-bancorpsouth).

It is possible that lenders use matched-pair testing to ensure compliance with fair lending laws. If they do, their results are privileged so long as the institutions take prompt corrective action in response to "likely violations identified by the self-test" (12 CFR § 202.15 ECOA; 24 CFR § 100.143 FHA). Thus, there is no way to know if or how banks utilize matched-pair testing. And, even if lenders perform matched-pair testing, the results are not available to the public or CFPB (12 CFR § 202.15).

The CFPB has made an exception to the self-testing privilege. The Bureau awarded a no-action letter to a lender, Upstart, as part of the Catalyst Program. A condition of the letter states that Upstart will provide CFPB with the results of its testing and the data underlying the test results (https://files.consumerfinance.gov/f/documents/201709_cfpb_upstart-no-action-letter-request.pdf). There is no evidence that Upstart uses matched-pair testing.

One could argue that automated underwriting and machine learning algorithms have eliminated the need for testing because loan officers and customers rarely communicate. While it is true that credit-related communications and decisions are increasingly made electronically– especially when the credit is something other than a home loan, it is also true that there are customers who want to interact with live people over the phone or at a brick-and-mortar office. They may not have a computer or the skills to use one to seek credit. They may want information about a special program at a bank. Or they may distrust lenders that are not a three-dimensional bank that they can visit. Whatever their reasons, the cases cited above reflect that people do still interact with banks and that some lenders do still discriminate.

For the CFPB to engage in matched-pair testing to determine whether a financial institution engages in discrimination when pricing or offering products, it would need to overcome the prohibition on filing false financial information for federal loans or federally-backed loans. Ideally, the Bureau could create financial records of "standardized customers" that testers could use when applying for credit. Alternatively, they could recruit people who would use their own credit records to test for discrimination, in which case, the Bureau would need a way to scrub the testers' application information from their credit files.

Matched-pair testing poses other challenges. One is that it works better for small entities. With large entities with many employees working for many customers, it would be hard to identify discriminatory behavior if only a single or a few employees were involved. In this situation, one would need a large number of tests to detect discrimination and to yield statistically powerful results.

Recommendations

There needs to be a comprehensive review of cases and empirical studies, demonstrating the value of testing, much of which has been conducted under the Fair Housing Act. For example, there is at least one law school that has an extensive HUD-funded matched-pair testing program for rental discrimination. Other research has used matched-pair testing to assess whether there is public accommodations discrimination. Additionally research should: (1) learn how federal investigative agencies, such as the FBI, develop alternative identities for agents, which could help the Bureau develop profiles for standardized customers that would be inscrutable; (2) determine whether it would be possible to secure cooperation from credit bureaus, the IRS, and possibly other providers of credit information to create standardized credit files for testers; and (3) determine whether the Bureau is bound by the prohibition on making false financial statements.

Use of Alternative Data in Credit Reporting and Scoring

Pamela Foohey

Executive Summary

Credit reports and scores are used by lenders, employers, landlords, and insurers. A good credit report and score are integral to economic citizenship. But research shows that certain populations are disproportionately likely to have poor or fair credit scores, or to be credit invisible or un-scorable. Credit invisibility and the use of traditional credit scores that rely on a limited set of inputs have brought proposals for the inclusion of additional information in scoring models—that is, alternative credit scoring. The inputs proposed to be added to credit reports and scores could replicate or worsen already existing disparities in credit scoring. As alternative credit scoring gains traction, the CFPB should track and analyze these scoring models, with an eye toward issuing guidance and rulemaking aimed at ensuring that alternative credit scoring does not worsen, overall, disparities in access to important products, services, and opportunities.

Problem

Credit reports and scores are central to individual's financial prosperity. Lenders, employers, landlords, and insurers rely on reports and scores to decide whether to extend credit, offer jobs, accept rental applications, and provide insurance, and to decide the terms of those agreements. A poor or fair credit score can result in lost employment opportunities, more expensive insurance policies, higher interest rates and costly credit terms, and larger down payments for housing and utilities. This is particularly problematic because individuals with lower credit scores they tend to have fewer resources and ability to cover higher expenses. To the extent that credit reporting and scoring influences people's access to jobs, housing, goods, and services, they can play a role in financial stagnation or downward financial spiral.

Research, including that conducted by the CFPB, has shown that certain populations are disproportionately likely to have poor or fair credit scores—most notably, people with low incomes and from communities of color. Credit scores largely rely on information about prior credit decisions. These prior credit decisions reflect a legacy of discrimination, such as redlining and aggressive marketing of subprime credit to people of color. As a result, credit scores reflect the United States' racial, ethnic, and economic disparities, and not people's ability to responsibly manage their finances or show that they will be trustworthy employees and tenants.

Nonetheless, because credit scores have become so fundamental to economic citizenship, consumer advocates have highlighted the problems faced by people who are credit invisible or unscorable. Black, Latinx, and lower-income individuals are more likely to lack a credit history sufficient to produce a credit score. As a response to credit invisibility and the use of credit scores that rely on a limited set of inputs, advocates, legislators, and financial regulators have called for the addition of information to credit scoring models—that is, alternative credit scoring.

Proposals regarding alternative scoring typically call for the inclusion of payment records from utilities, cable television and cell phone providers, and landlords. Some proposals call for the inclusion of work and school attendance history and a particular information from Internet usage. Most recently, Maryland enacted a law that, as of October 2021, requires financial institutions to consider "alternative indications of potential creditworthiness," such as rental or mortgage payments, utility payment history, school attendance, and work attendance. In September 2021, Fannie Mae announced that it will incorporate rental payments in its automated underwriting system for mortgages. And, as the beginning of

2022, Equifax announced that it was incorporating buy now, pay later payments into credit reports.

Proponents of alternative credit scoring tout it as a solution to many of credit scorings' problems, from credit invisibility to the potentially detrimental effect of errors in the information reported to credit bureaus incorporated into traditional credit scores. Although alternative credit scoring may help some individuals, overall, the use of alternative data will not necessarily make those individuals with lower credit scores more attractive because they generally may perform below-average on many of the inputs. As such, alternative credit scoring could replicate or worsen already existing disparities in credit scoring. Indeed, the continued legacy of economic, racial, and ethnic inequality is so pervasive that almost every data point included in alternative scoring models may reflect socio-economic factors beyond people's control.

Recommendations

Research. The CFPB, in the past, has published research about demographic disparities in credit scores and demographic disparities in people reporting mistakes on their credit reports. The inclusion of additional data in credit reporting and scores is a new and evolving aspect of credit reporting and scoring worthy of tracking and analysis. Key questions include: in what contexts are alternative data being used; what alternative data is being used; the demographics of people with alternative credit reports and scores; the demographics of decisions based on the use of alternative credit data; the extent to which people are allowed to opt-out or opt-into alternative data being used in decisions; how the alternative data usage is being reported to consumers; and whether and the extent to which there are errors in the reporting of alternative data used.

Relatedly, the new data proposed to be included in alternative credit reports and scores include products and services that people may make strategic financial decisions to fall behind on at certain times. For instance, people may decide to put off paying their heating bills because of laws prohibiting utility companies from shutting off heat during cold weather. If money is tight, not paying a heating bill may be an indication of good financial judgment. But if included in alternative credit scores, the failure to pay this bill likely would hurt consumers. In researching the effects of alternative credit scores, the CFPB also should consider how new inputs that are used interact with other laws that provide financially sound reasons to behave in ways that may negatively impact alternative credit scores.

Regulatory action. Based on its analysis, the CFPB has the authority to issue guidance and engage in rulemaking regarding alternative data in credit reports and scoring. Regulatory action in regard to alternative credit scoring necessarily will depend on the depth and breadth of adoption of alternative credit scoring. Prior research regarding traditional credit reporting and scoring has identified a few main issues: inaccuracies in reporting; difficulties in fixing inaccuracies in reporting; and use in contexts where the validity of reporting and scoring as a proxy for trustworthiness is questionable or serves to deny certain populations access to important products, such as insurance. Alternative credit scoring may exhibit similar concerns. For instance, the CFPB may find that the market lacks transparency about the reporting and inclusion of data, that there are widespread inaccuracies in the data included, or that people are harmed by the ability to opt out or opt into alternative data's inclusion.

Classification of Credit Transactions Styled as Novel

Jonathan Glater

Executive Summary

Lenders providing credit in forms that they characterize as novel seek to avoid compliance with federal laws directing disclosure of loan terms and prohibiting discrimination on the basis of membership in a protected class by asserting that financial products are not loans. Possible responses include individual enforcement actions against entities selling these products and rulemaking to implement a broader definition of credit, thereby making it more difficult for a creditor to argue that relevant laws are not applicable.

Problem

In various consumer contexts, businesses functioning as lenders claim that transactions they market do not involve the extension of credit. By making this claim, the selling business (in reality, the lender) can rationalize noncompliance with laws either imposing affirmative obligations on the lender or prohibiting certain practices. These laws, including the Truth in Lending Act and the Equal Credit Opportunity Act, explicitly apply to transactions involving the extension of credit. See 15 USC §1601 et seq. (TILA) and 15 USC §1691 et seq. (ECOA). If such prohibitions of discrimination and/or affirmative disclosure requirements do not reach these consumer financial transactions, that denies a remedy to consumers who fall victim to conduct that would violate the laws if the transactions were accurately classified. Lenders could more readily engage in discrimination on the basis of race and use deceptive practices in dealings with members of racial minority groups.

Here are three examples of products lenders offer but define as transactions that do not involve credit:

- "Income share agreements." These financial products are marketed to postsecondary students as alternatives to traditional student loans offered by the federal government or commercial lenders. Rather than agreeing to repay a lender the amount borrowed plus interest, as a standard promissory note would require, borrowers who use income share agreements ("ISAs") instead pledge to repay a fraction of their income upon completion of the course of study financed using funds provided by the lender. The amount actually paid thus is contingent upon the earnings of the borrower rather than the size of the loan. Both the Bureau and at least one state regulator (California) have taken the position that these ISAs do constitute loans and therefore are subject to laws governing credit, but the full implications remain unclear. For example, must lenders disclose an effective annual percentage rate under various income scenarios?
- "Home equity investments." Similarly, lenders market themselves as co-investors in a borrower's real property. Instead of making regular payments as with a mortgage or home equity loan, the borrower "settles" the loan at any point within a period of years. The amount repaid is contingent upon the value of the home; the lender has a claim to a "share" of the home. Again, characterizing the transaction as an investment and not a loan implies that laws applicable to extensions of credit do not apply.
- "Training Repayment Agreements." These agreements, often included unobtrusively in employment contracts, require employees to reimburse employers for the cost of training provided by the employer, if the employee changes jobs within a certain time period. Such penalties for quitting effectively convert employees into debtors if they leave, functioning like noncompete agreements (which in some states, like California, would otherwise be illegal). Yet again, the financial impact of the transaction is contingent, this time on both the decision to leave

the employment relationship and on the cost assigned by the employer to the training. And once again, the employer may skirt laws governing the extension of credit that would otherwise apply.

Recommendations

Research. These and other transactions involve putatively novel transactions intended to exploit imprecision in the definition of credit. Critical research would thus aim to identify and perhaps anticipate such transactions and monitor their prevalence. Complementary research would survey disparate statutory frameworks in need of legislative update or regulatory interpretation to encompass these transactions.

Regulatory action. The CFPB has authority because these transactions involve financial products covered by12 USC §5481(15). The Bureau could use enforcement actions to shine a light on these consumer financial transactions and put other businesses on notice that they should not attempt to characterize loans as transactions other than loans. One risk of this approach is lenders might continue to try to innovate, or at least claim to innovate, leading to an ongoing game of whack-a-mole for regulators responding to each novel credit product. Another risk is the passage of time, because new credit products may grow popular and then be more difficult to disallow. The Bureau could also engage in rulemaking to implement a definition of credit that is sufficiently broad that it encompasses diverse financial transactions like those described above. One challenge to this is the contingent nature of the repayment obligations: there are circumstances under which a debtor may not be required to pay. An effective regulatory fix should provide a borrower with a meaningful opportunity to engage in comparison shopping for loan products.

Fairness and Competition in Consumer Financial Markets

Luke Herrine

Executive Summary

This memo encourages caution in prioritizing the promotion of "competition" in consumer financial markets. Competition is too vague a term to provide useful guidance in most cases. And—whether it means low barriers to entry, minimal market power, strategic price cutting, or something else—it is not reliably beneficial for borrowers on the whole or fair to the most vulnerable borrowers. The Bureau's overarching goal should be to promote fair treatment, and it should closely consider under which circumstances competition (in its various forms) does so.

Problem

In early speeches and regulatory actions, Director Chopra has made clear that he wants to expand the CFPB's efforts to "promote competition", in part because of President Biden's Executive Order creating a "whole-of-government policy" to do so (though in the CFPB's case, the Executive Order is precatory). Exec. Order No. 14,036 (Jul. 9, 2021). While a focus on market power and some of the specific regulatory actions that have gone with it so far are welcome, there are potential pitfalls with orienting an agency designed to protect the interests of consumer borrowers around "competition".

One issue is conceptual. What does it mean to "promote competition"? In simple neoclassical models that guide much discussion, a consumer market is "competitive" if there are enough sellers and low enough barriers to entry that all sellers are (or think they are) compelled to price goods/services of a given quality at marginal cost. To "promote competition" is thus to attempt to prevent any seller from creating barriers to entry, thus forcing all sellers to compete with each other to provide the highest quality goods to everybody at the lowest possible cost.

There are all kinds of problem with using this simple model to make sense of actual markets. For example, given returns to scale, strategic pricing across markets (loss leaders, e.g.), product and brand differentiation, and the like, even firms who are actively worried about losing market share to rivals almost never price at marginal cost. Indeed, firms generally use a cost-plus pricing approach that involves making separate decisions about output and price. Perhaps more germanely for consumer markets, removing barriers to entry and otherwise encouraging active competition can just as easily lead to firms competing to take advantage of consumers' vulnerabilities as to competition for the optimal mix of price and quality.

Once one accommodates these complications, there is often no simple story about what makes a market more or less competitive. Does it mean removing barriers to entry (what if those barriers involve high cost of capital investment or a foundational regulatory norm separating finance from commerce)? Does it mean striving to ensure that consumers have more options in any given product market and/or that any given subset of consumers has more options? Does it mean ensuring that consumers have a sufficient understanding of products and probability estimates that their choices meaningfully reflect their judgments about quality/price tradeoffs? If these cannot all be done at once, then what?

As Sandeep Vaheesan has emphasized, the difficulty in articulating which state of a market is more or less "competitive" on a single scale has made the notion of "protecting" or "promoting" competition stand in for other values. Sandeep Vaheesan, *The Morality of Monopolization Law*, 63 Wm. & Mary L. Rev. Online (forthcoming 2022).

That brings us to the other issue, which is more practical: competition, as it actually exists as a dynamic process in real markets, has only a contingent relationship to other values we might strive for in consumer financial markets. Competition to push more costs into "junk fees". Perhaps less obviously, competition to perfectly price borrower risk is a race to make lending markets more closely reflect the way our society has distributed risk to reinforce racialized hierarchies (including, most obviously, by creating an enormous racial wealth gap), thus reinforcing racial discrimination. And competition to introduce new lending products that arbitrage existing regulatory frameworks undermines the protections conferred by those frameworks. Especially in the domain of finance, there is a long history of more competition meaning a less stable and more predatory system.

Why does this matter? Let us examine three examples of matters confronting the CFPB to illustrate.

First, take the recent initiative to target high credit card interest rates and fees. In a recent blog post, two CFPB researchers assert that "[i]f there were more intense competition to refinance [credit card] balances, customers could save billions." Ashwin Vasan & Wei Zhang, *Americans Pay $120 Billion in Credit Card Interest and Fees Each Year*, CFPB Blog (Jan. 19, 2022), https://www.consumerfinance.gov/about-us/blog/americans-pay-120-billion-in-credit-card-interest-and-fees-each-year/. That might be true, but we should not assume that making it easier to refinance credit card balances (whether via Section 1033 rulemaking or otherwise) would automatically be beneficial. To oversimplify, competition over rates in credit card markets tends to benefit borrowers who pay the closest attention and who have higher credit scores. And low rates (and reward programs) for some borrowers are cross-subsidized through higher rates and predatory practices focused on inattentive and financially more precarious borrowers (they are also subsidized in part through interchange fees). So competition to refinance credit card balances may well result in lower rates for many borrowers, but it is not clear without further research exactly *which* borrowers would benefit, and so whether the net result would be fairer or less fair credit card markets. That is so even if there would be a net savings for all credit card borrowers (i.e. a transfer from lenders to borrowers, *on net*).

Second, focusing on competition and ease of entry is an especially bad frame for thinking about the all-important question of how to regulate new entrants from "Big Tech". It is precisely in the language of "innovation" and "competition" that Facebook and others justify their attempts to break down of the line between commerce and finance via "fintech" offerings. As Lev Menand, among others, has pointed out, holding the line between commerce and finance is a key aspect of sound financial governance, and eroding it could be destabilizing to the monetary system. Lev Menand, *Why Supervise Banks? The Foundations of the American Monetary Settlement*, 74 Vand. L. Rev. 951 (2021). And it is precisely by competing on price that fintech companies justify their surveillance regimes, thus obscuring the deep questions involved with how surveillance erodes privacy, entrenches inequality, and squelches democratic dissent. And this is a path-dependent phenomenon. If surveillance-based business model are encouraged to compete and take up a large enough portion of the market, they will ultimately become "too big to fail", locking in surveillance as a precondition for lending absent a major restructuring of business and regulatory models. (Similar worries apply to the Chamber of Commerce's complaints about regulation in light of competition from China.)

Third, the CFPB's efforts to compel the FDIC to enforce the Bank Merger Act more rigorously are welcome but not easily framed as "promoting competition". Joint Statement of Martin J. Gruenberg & Rohit Chopra, Members of FDIC Board of Directors (Dec. 9, 2021), https://files.consumerfinance.gov/f/documents/cfpb_bank-merger-act-rfi_joint-statement_2021-12.pdf. The Bank Merger Act instructs the FDIC to consider "the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, and the risk to the stability of the United States banking or financial system." As Director Chopra has pointed out, these factors have not been well fleshed out. But what is clear is that they focus on matters that are only contingently related to the dynamic process of competition or the relation of markets to an ideally “perfectly competitive” one. Rather, they ask practical questions about how a merger is likely to impacts the communities who are or might be served by the financial institutions question—with a special focus on the most vulnerable borrowers, on the way that consolidation will impact financial stability (which can be actively *undermined* by too much competition between lenders), and on how the merger will affect the ability of a bank to function (given the mix of good and bad debts, the possibilities of lowering costs through consolidation of records and products, etc.). To focus on “competition” rather than the details of these factors would only distract from the purpose of the statute.

Recommendations

My main recommendation is that the CFPB should exercise care in “promoting competition”. Analytically, that means being clearer about what “competition” means, which will usually mean decomposing it into separate concepts (barriers to entry, market power, etc.). Indeed, it might mean focusing on the separate concepts that travel under the rubric of “competition” rather than on the umbrella concept itself. And I myself would be inclined to label the overall approach as “anti-monopolist” or “anti-domination” rather than “pro-competition”. A better overall rubric would be to promote “fairness” (as the CFPA already commands) rather than “competition”, with the latter only instrumentally valuable to the former.

In my view, a more sensible understanding of competition—one that can be found, in different ways, in the literatures growing out of Chamberlin, Hayek, Schumpeter, Andrews, Marx, Lee, and others—sees it as a *dynamic process* of striving for market share and increased profit that can be both productive and destructive (even at the same time) and that can take place in both highly concentrated and highly diffuse markets. This type of competition is something that must be channeled rather than always promoted. That means *restricting* competition in various ways. Many of the statutes the CFPB enforces already do this: preventing competition over ways of representing interest rates, over ways to steer Black and white borrowers to different mortgages, etc.

Here is a first go at what the values involved with an anti-domination approach might look like:

- Fair prices (which doesn’t mean lowest possible for all borrowers, because that’s too unequal across borrowers: it means minimal markup across a whole market with cross-subsidizing relatively flat rates across borrowers) and fair terms
- Fair competition (which is not the same as *more* competition, per se, it involves setting rules for engagement and prohibiting competition on some factors to focus it on others)
- Geographic diffusion of lenders
- Inclusion, by race, gender, religion, disability, immigration status
- Consumer autonomy: understandable terms, easy shopping, easy assertion of rights
- Separation of commerce and finance and otherwise ensuring monetary stability
- Preventing consolidations of power that can corrupt governance
- Preventing regulatory arbitrage that undermines regulatory and monetary stability

But this is only an initial list. If the CFPB is to take on the project of thinking about consumer financial markets through the lens of power, it should more carefully consider its own.

Discrimination in "Workouts" and Collection Activity

Dalié Jiménez

Executive Summary

When borrowers are unable to repay their obligations, they are typically contacted by their lenders or servicers to attempt to work out a resolution. We know that both the reaching out and granting of forbearance/other contractual waivers/modifications happens unequally, often along racial lines. This violates the Equal Credit Opportunity Act as well as in many cases should be considered "unfair" under the Consumer Financial Protection Act.

Problem

The current COVID-19 crisis is likely to dovetail into a debt collection pandemic. There are already signs of this, with banks like JPM Chase picking up their volume of debt collection lawsuits in 2021. While the latest FRBNY Quarterly Report on Household Debt shows a decrease in delinquent accounts and accounts in collection, a reckoning is likely coming (likely after student loan payments resume). There is documented evidence that the offer of workouts (payment pauses, forbearances, waivers of fees, etc.) happens unequally across racial and other socioeconomic lines.

Recommendations

Research. A research agenda in this space would involve monitoring markets using Bureau research data (e.g., Consumer Credit Panel research), supervisory information, and potentially civil investigative demands to some firms.

It should also involve obtaining state-level lawsuit information from courts or others collecting such information (see, e.g., the Debt Collection Lab and ongoing research in California). Although lawsuits are but the tip of the iceberg in the world of debt collection, this would give the Bureau some data on one part of the equation.

The goal would be to answer questions like:

- How are lenders/services/collectors offering workouts/forbearances/waivers to consumers?
- Are there policies/procedures in place that might have a discriminatory effect?
- Is there a disparate impact to the way lenders/services/collectors approach workouts? (supervisory data would be ideal for this)
- Are lenders/services/collectors profiting from keeping consumers in the "sweat box" of credit (or collection) in ways that have a disparate effect upon protected classes?

Such a research agenda could go beyond the typical lenders/servicers we might think of and using the discrimination in debt collection as unfairness framing could also expand to evictions, particularly by large landlords.

Regulatory Action. The CFPB should at minimum issue a policy letter warning lenders/covered persons that their workout practices may have a disparate treatment effect on protected classes. Ideally, they would also provide some guidance as to how to avoid that. For example, by testing for disparate granting of forbearances/workouts among their clients. Foohey, Odinet, and I wrote a bit more about this here.

The Bureau should test for disparate impact in collection/post-delinquency treatment in supervisory datasets and in state debt collection lawsuit datasets.

The Bureau should issue a policy letter that mirrors then Commissioner Chopra's points in an FTC case that discriminatory treatment (whether intentional or simply has that effect) is often "unfair" under the CFPA/FTC Act and similar statute. The Student Borrower Protection Center expanded upon Director Chopra's argument in a 2021 report.

Predatory Lenders’ Targeting of Communities of Color

Creola Johnson

Executive Summary

Companies that offer payday loans, installment loans, flex loans, car title loans and other high-cost, short-term loans target communities of color with false and misleading advertising. Commercial speech is protected so long as it is not false or misleading. Lenders are subject to enforcement under the Equal Credit Opportunity Act. Unfortunately, the ECOA does not expressly prohibit false or misleading advertising on the basis of race, ethnicity or national origin. Possible responses could include rulemaking aimed at protecting communities of color from false and misleading advertising and requiring companies to disclose the harmful impacts of their loan products in their various forms of advertising.

Problem

In advertisements of various high-cost loan products targeted to communities of color, the lenders never disclose potentially harmful aspects of their products. The Federal Trade Commission Act prohibits unfair and deceptive acts or practices and false advertising. False and misleading advertisements pose a serious risk to black and brown consumers who often do not understand the features, risks and obligations of high-cost short-term loans. For example, car title lending TV commercials explain how easy it is to obtain a car title loan, but no commercial actually discloses that a consumer could lose ownership of her car if she defaults on a car loan. Because a car title lender requires borrowers to prove that they own their vehicles, it would not occur to many, if not most, borrowers that they could lose ownership of a car that they actually own. The ECOA does not explicitly prohibit false and misleading advertising on the basis of race, ethnicity or national origin.

Here are two examples of advertised loan products that fail to disclose relevant harmful outcomes if borrowers default:

- “Car Title Loans”- TitleMax is the largest car title lender. While TitleMax’s loan documents may disclose the possibility of repossession, the company’s TV commercials do not even hint at the possibility that a borrower could lose his or her vehicle. Even if the company’s repossession rate is relatively low, which is debatable, the consequences of repossession are enormous (e.g., loss of job after car is repossessed). Therefore, companies should be required to disclose the risk of repossession.
- “Flex Loans”- American Financial is one of the largest companies offering the flex loan product, which is really an open line of credit, generally up to $4,000. Borrowers who are approved can withdraw any amount up to their maximum limit anytime. The TV commercials do not tell the borrowers about the triple-digit interest rates and other terms that make it difficult for borrowers to actually repay the loan.

<u>Research</u>. A recent study co-authored by University of Houston Law Center Professor Jim Hawkins and student Tiffany Penner indicates that the payday lending industry often targets Black and Latino communities in advertising their products, while mainstream banking institutions target white consumers—featuring almost all whites in their ads. ("Advertising Injustices: Marketing Race and Credit in America," 70 Emory L.J. 1619 (2021)). For example, the study found that 77% of advertisements at physical store locations of auto title and payday lenders in the study targeted racial minority groups. Further research is needed to show the various forms of advertising targeted to communities of color. Such research could, for example, focus on advertising in Spanish only newspapers and TV channels.

Rulemaking action. The Consumer Financial Protection Act explicitly provided that "[t]he [CFPB] shall have all powers and duties under the enumerated consumer laws [which includes the ECOA] to prescribe rules, issue guidelines, or to conduct studies or issue reports mandated by such laws, that were vested in the Federal Trade Commission on the day before the designated transfer date." 12 U.S.C. § 5581(b)(5)(B). The CFPB could prescribe rules that put restrictions on the advertising of high-cost credit to communities of color and require lenders to make certain disclosures in their print, TV, radio, and social media advertising.

Disparate Impact Standards, Including Specifically for Artificial Intelligence

Adam Levitin

Executive Summary

Many lenders now use artificial intelligence (AI) as part of their underwriting process. The nature of AI lending applications means that lenders may not understand exactly how underwriting inputs produce underwriting outputs, making it difficult to understand why there might be a disparate impact on protected classes and whether there is a less restrictive alternative.

The Bureau should promulgate its own disparate impact rule under Reg B that (1) expressly provides for disparate impact liability, (2) sets forth an analytical framework for determining when disparate impact produces liability, and (3) specifically addresses the particular complications AI presents for disparate impact analysis.

Problem

Lenders are increasingly adopting artificial intelligence (AI) applications, such as neural networks and machine learning for their underwriting. Whereas traditional algorithmic underwriting involves a linear relationship between underwriting inputs and outputs that can be analyzed by both the lender and third parties (regulators or plaintiff), AI masks the relationship between inputs and outputs. Lenders often do not understand how or why AI produces the outputs that it does, only that they are optimized for profitability.

This means that AI applications can potentially rely on data that functions as a proxy for protected classes without lenders even being aware. For example, if a lender were to use borrowers' ZIP codes in a traditional algorithmic underwriting approach, the potential for that to be a proxy for race would be obvious. But if an AI application is turned loose on a large borrower data set for learning and then subsequently fed borrower applications, the lender might not be able to tell if the AI application was using borrower ZIP code information as a factor in its underwriting.

AI poses a substantial challenge for fair lending laws that prohibit not just facial discrimination against protected classes, but also practices that have a disparate impact on protected classes. The "business necessity" defense to disparate impact cases casts a considerable legal obstacle to the enforcement of fair lending laws because it is near impossible to show that there is a less restrictive alternative that would accomplish the same business purposes. This is particularly true with AI because without an understanding of how the underwriting actually works, it is impossible to say that another alternative would accomplish the same business ends. This suggests that AI should be treated differently under fair lending laws than traditional algorithmic underwriting.

Recommendations

<u>Research</u>. A key supporting piece of research for a Reg B rulemaking would be a Bureau study about the frequency of lender use of AI applications and the nature of these applications. A study that explains the use of AI in lending in lay persons terms would be key for helping policymakers understand the issues.

<u>Regulatory action.</u> The CFPB should consider a ECOA/Reg B rulemaking on disparate impact that specifically addresses AI. ECOA/Reg B are silent about disparate impact as a theory of liability, but SCOTUS has endorsed disparate impact theory in the parallel context of the Fair Housing Act. *Texas*

Dept. of Housing and Community Affairs v. Inclusive Communities Project, 576 U.S. 519 (2015). *Inclusive Communities Project* was a statutory interpretation decision dealing with a statute not administered by CFPB and it was not a constitutional ruling, so the CFPB is not bound by the Supreme Court's interpretation of how a disparate impact litigation must proceed. While *Inclusive Communities Project*'s burden-shifting analysis is often assumed to extend to ECOA, it does not formally, and even if it did, the CFPB has the power to override SCOTUS's statutory interpretation gloss through notice-and-comment rulemaking. This leaves the CFPB with the freedom to tailor or alter or even abandon the burden-shifting analysis as it desires.

To this end, the CFPB should, in the first instance, amend Reg B to specifically provide for a disparate impact theory of liability. The Bureau should also set forth a process that it believes is a fair approach to balancing statistical evidence of disparate impact and legitimate business needs. In particular, however, the Bureau should consider whether a special approach is appropriate for AI-based extensions of credit, at least when the defendant cannot itself explain how underwriting inputs are translated into underwriting outputs that produced disparate impacts.

In effect, the Reg B should recognize that as part of lenders' obligation to avoid discriminatory practices, it is grossly negligent to operate an underwriting system where the lender does not understand how the inputs result in the outputs. A lender that does not understand how its own underwriting system produces outputs and fails to maintain adequate safeguards against disparate impact should probably not be afforded a "business necessity" defense. Instead, an AI-specific disparate impact rule should indicate what sort of safeguards a lender that relies on AI would be required to take to qualify for a rebuttable safe harbor, at least against Bureau enforcement actions.

The Entry of Credit Card Companies into the Buy Now Pay Later Market

Angela Littwin

Executive Summary

Buy Now Pay Later (BNPL) apps such as Affirm, Klarna, and Quadpay offer the first serious competition to credit card lending in decades. While BNPL itself poses problems, BNPL apps build most of the cost of credit into the sticker price of the loan and thus offer a relatively consumer-friendly challenge to the credit card lending model, which depends on back-end interest and fees for profitability. Credit card issuers, however, have begun offering their own BNPL plans, which may confuse consumers who have begun to depend on the comparatively transparent pricing of BNPL and increase the number of consumers using revolving credit. Basic information about credit card BNPL is needed.

Problem

BNPL apps offer short-term installment loans for consumer purchases. The interest charged is incorporated into the installment payments that the consumer selects when making the purchase. Thus, the true cost of credit is apparent to consumers from the beginning of the transaction, at least when consumers pay according to terms. And when consumers miss payments, BNPL do charge additional fees, but the loan defaults, which provides notice to the consumer that the debt is unaffordable. In contrast, credit card borrowers who make the minimum payment (or close to it) can remain in good standing for months or years without realizing that they are accumulating unaffordable debt. Consumers often do not understand how quickly interest and debt multiply, especially because most issuers calculate interest so that it compounds daily. The ubiquitous promotional interest rates as low as zero percent further obscure the total cost of credit.

The entry of credit card issuers into the BNPL market has the potential to blur the line between installment and revolving credit, leaving consumers confused and paying more than they expect. Furthermore, competition from credit card issuers could cause BNPL apps to modify their pricing in the direction of less transparency. The most important problem at this point is that information is lacking about the integration of BNPL into credit card issuers' traditional pricing practices, which rely on shrouding the cost of credit through back-end interest and fees.

Below are three examples of questions necessary to analyze the risks that credit card BNPL poses to consumers.

- How do credit card issuers handle defaults on BNPL plans? Does unpaid BNPL debt become part of a consumer's revolving balance? The concern is that what begins as debt for which the sticker price reflects the true cost of credit could become debt in which back-end pricing obscures the cost of credit. Debt that begins as BNPL and becomes revolving could also take much longer to pay off than consumers expect.

- What types of consumers are using credit card BNPL? If consumers who regularly revolve balances are substituting BNPL credit for revolving debt, that could be a positive development that increases price transparency. But if transactors use BNPL to begin borrowing on their credit cards, that could increase the total level of consumer credit card debt. It also bears watching to see the extent to which former transactors pay off BNPL debt according to terms or end up paying back-end interest and fees.

- How does the pricing of BNPL apps evolve in response to competition from credit cards? Currently, one reason that BNPL apps charge consumers low prices is that merchants subsidize the transactions. But given the contentious history of merchants fighting credit card interchange fees, which are lower than the fees merchants pay BNPL apps, merchant subsidization of BNPL will probably decrease. (Indeed, I suspect that the potential for a new competitor to credit cards is an important reason why merchants are tolerating BNPL fees now. Merchants must be expecting competition to bring lower fees in the future.) When merchants pay less, consumers will almost certainly pay more. The question is the extent to which BNPL apps continue their relatively transparent pricing practices. The concern is that, when prices are higher, competitive pressures could push BNPL apps into obscuring the total cost of credit by lowering up-front prices and increasing back-end charges that are less salient to consumers.

Recommendations

Research is the most pressing current need. A section in the CFPB's next The Consumer Credit Card Market report would be an ideal place to address questions like those outlined above. Past reports have provided key information about cutting-edge developments, such as the section on deferred interest promotions in the 2015 report and the more recent sections on third party comparison websites. BNPL generally and BNPL as offered by credit card issuers are equally important topics.

Regulatory action. Given the lack of available data, it is premature to engage in actions such as rulemaking or enforcement on these issues, but opening an inquiry into credit card BNPL as the Bureau just did for BNPL in general would be a strong first step. Including BNPL as a topic in the Bureau's supervision of credit card issuers would be another fruitful approach.

Racial and Socioeconomic Disparities in Mortgage Lending

Patricia A. McCoy

Executive Summary

Homeownership is the most important source of wealth for lower-income and minority households, yet homeownership rates for both groups lag that of White Americans. In view of the past few years of deregulation through 2020, it is important to examine ways in which new technologies or CFPB regulations may inadvertently reinforce mortgage discrimination against minority borrowers. This memorandum discusses that issue with respect to three developments: algorithmic underwriting, the 2020 General and Seasoned Qualified Mortgage rules, and mortgage servicing of distressed loans.

Problem

For ordinary American households, homeownership is the single most important driver of wealth. This makes sustainable access to mortgage credit vital to narrowing the wealth and homeownership gaps, particularly for Blacks, Hispanic-Americans, and other groups who historically were shut out of homeownership due to *de jure* and *de facto* segregation. The country is moving backwards, moreover: the homeownership gap between Black and White Americans for 3Q 2021 (30%) was greater than in 1960 (26%), before the passage of the Civil Rights Act of 1968.

Traditionally, discussions of access to mortgage credit have revolved around two issues: (1) how to expand access to mortgage credit; and (2) how to accomplish this while minimizing default risk. After the past few years of deregulation, however, renewed attention is needed to examining ways in which new technologies or current federal regulations may reinforce the homeownership gap inadvertently. It is possible, for instance, that federal rules or emerging industry practices unintentionally open the door to discriminatory or exploitative mortgage practices targeting unsophisticated or vulnerable consumers, especially first-time homebuyers or homeowners. Insofar as these consumers are lower-income or people of color, the potential for exploitation threatens to aggravate the wealth and homeownership gaps. The following three areas warrant attention.

1) *Algorithmic Underwriting and Discriminatory Loan Denials:* Black and Hispanic-American homebuyers are consistently more likely to be turned down for mortgages than comparably qualified White applicants. Today, loan underwriting is increasingly done by algorithms. At least one major study reported that Black and Hispanic-American mortgage applicants were turned down more often under such algorithms than comparably qualified Whites. There are various possible reasons why algorithms produce discrimination, such as biased inputs (*e.g.*, from sources such as credit reports), the use of proxies for race, and/or human discretion in the use and review of the feedback's recommendations and in imposing other overlays based on unobservables.

2) *Steering of Minority Customers to Higher-Priced Loans:* In the wake of the 2008 subprime crisis, it was well-documented that Blacks and Hispanic-Americans paid higher interest rates and fees for mortgage loans than Whites, controlling for creditworthiness. In part, this steering took advantage of discretion in the pricing of home mortgages. The new CFPB rules redefining a General Qualified Mortgage (QM) and creating a Seasoned QM introduce new legal incentives for discretion in mortgage pricing that could encourage discriminatory steering.
Specifically, in December 2020, the CFPB finalized a rule mandating a new definition of a General QM. 85 Fed. Reg. 86,308. Loans that meet the definition of a QM receive a safe harbor from liability for ability-to-repay (ATR) violations. In the 2020 rule, the Bureau dropped the

debt-to-income (DTI) ratio cap in the original General QM definition and replaced it with a price-based approach. Under that approach, first-lien loans of $110,260 or more can be General QMs if their APRs exceed the average prime offer rate (APOR) by less than 225 basis points as of the date the interest rates were set. The final rule sets even higher price thresholds for other home mortgages. In April 2021, the Bureau delayed the date for mandatory compliance with the new rule until October 1, 2022. Lenders have been allowed to use the new price-based approach, however, since March 1, 2021.

In December 2020, the Bureau also issued the final seasoned QM rule, which creates a major loophole to the new General QM rule. Under that companion rule, seasoned QMs give portfolio lenders safe harbor status for subprime loans with high DTIs and annual percentage rates (APRs) of up to 9.67% at today's rates, so long as those lenders hold the loans for 36 months.

The size of these price thresholds creates an anchoring effect that could encourage lenders to steer unsuspecting minority customers to loans at or near the top of the price spread. As a consequence, affected customers face a heightened risk of default on top of paying more. In the final rule, the Bureau concluded that the new General QM definition "is likely to increase the number of consumers who become delinquent on QMs, meaning an increase in consumers with delinquent loans who do not have the benefit of the ability-to-repay causes of action and defenses against foreclosure." The Bureau's default risk analysis similarly estimated that foreclosure start rates of seasoned QMs would be *twice to 8 times higher* than for previous era safe harbor loans. Borrowers who end up defaulting through job loss or illness will pay the ultimate price in the form of lost equity, ruined credit, and often the loss of the roof over their heads. Historically, these borrowers have been disproportionately lower-income and people of color. Further, they also will have lost legal recourse against their lenders for any violations of the ATR rule.

3) *Discrimination and Exploitation in Mortgage Servicing:* Mortgage servicers exert market power because borrowers do not choose their servicers. On top of that, servicers exercise broad discretion in whether to grant loss mitigation or foreclose when servicing distressed home loans. This combination of market power and discretion creates room for disparate outcomes in the distribution of loss mitigation remedies versus foreclosure by race and ethnicity. The availability of home retention remedies has assumed heightened importance as Covid-19 forbearance programs expire.

Recommendations

Research:
Mortgage Underwriting Algorithms:

- Document the extent to which these algorithms result in discriminatory loan denial and pricing outcomes according to race and ethnicity.
- Analyze what aspects of the algorithmic process produce discriminatory results (including biased inputs such as credit histories) and how they can be rectified.
- Research how to improve self-testing and supervision of algorithms to reduce discriminatory impact.

Steering to Higher-Priced Mortgages:

- Does the new price-based approach to QMs increase the likelihood that minority borrowers will (1) pay more for mortgages than comparably creditworthy Whites and how large are any pricing disparities; and (2) have higher default risk than comparable Whites? How does a rising rate environment affect the answer?
- Compare the effect of the price-based approach to the DTI cap approach on: (1) access to

mortgage credit by race and ethnicity; (2) default risk by race and ethnicity.

- To what extent do the following result in adverse disparate impacts for minority borrowers: (1) the ability to raise interest rates and fees between application and closing; and (2) the lack of a mandatory no-points option?

Sustainable Mortgages (i.e., mortgages that jointly optimize access to credit and default risk):

- Examine what combinations of loan features, underwriting practices, pricing, and marketing practices jointly optimize access to credit and default risk.
- Evaluate current models for more sustainable mortgages (such as the ONE Mortgage) and how to bring them to scale.

Discriminatory Servicing Outcomes: What is the relative distribution of home retention options versus foreclosure among comparably performing delinquent borrowers who are Black or Hispanic versus White?

Regulatory Action:
Mortgage Underwriting Algorithms:

- Institute more robust self-testing and fair lending supervision for discriminatory denials and pricing.
- Ascertain discriminatory bias embedded in inputs such as credit records and formulate effective regulatory responses.
- Require notification to mortgage applicants and borrowers who suffered discriminatory effects under algorithmic models.

Steering to Higher-Priced Mortgages:

- Revisit eliminating the price-based approach to General QMs and repealing the Seasoned QM definition.
- Revisit reinstating a DTI test for General QMs but making it more flexible.
- Tighten the tolerances for mortgage price increases at closing under TILA.
- Require a no-points mortgage option.

Discriminatory Servicing Outcomes:

- Require data reporting on servicing outcomes by race and ethnicity.
- Ramp up fair lending examinations for discrimination in servicing outcomes.

The Need for Coherent Regulatory Attention to Substitutability and Complementarities in High-Interest Credit Markets

Paige Marta Skiba

Executive Summary

Although regulators often assess the terms of particular types of credit in isolation, consumers approach borrowing differently and switch among a variety of sources of credit for myriad reasons. This means that when the availability or terms of one source of credit shift in an adverse direction, the borrower may substitute a different form of credit. Regulators in an increasingly diverse credit environment must attend to the possibility that reining in harmful lender conduct with respect to one type of credit may result in consumer use of another form of credit with comparable or worse effects: regulators must monitor the landscape.

Problem

Consumers use multiple types of credit simultaneously: for example, pawning collateral to roll over a payday loan; seeking an auto-title loan when one's credit card liquidity is growing thin, etc. Consumers also substitute between products: turning to installment loans or the new so-called "flex loans" when payday loan availability is restricted. (The new high-interest flex loans are described in more detail below.) While this interconnectivity may seem obvious, regulators often view a single type of credit, and regulation of it, as a silo, ignoring the important interactions and simultaneous use of credit products. These include spillover effects, substitutions between types of credits, and complementarities. Examples of the latter include the simultaneous use of credit card and payday loans and the use of pawn borrowing to pay off payday loan balances.

Beyond understanding how consumers manage multiple types of debt simultaneously and pivot when a ban or restriction is imposed, it is also important to understand the fluidity of the supply side: Lenders can and do respond nimbly to proposed changes at the state and federal level by crafting new types of credit products just outside the reach of regulators. The quick and quiet creation of flex loans in Tennessee is a good example. Often these new alternatives come with higher costs and more opaque terms, potentially leaving consumers worse off despite regulators best attempts at keeping products safe. The demand for small dollar, high-interest credit is strong. The CFPB plays an important role in keeping these products safe for consumers.

Recommendations

Research. Relationships among types of credit, meaning the choices consumers make about complementing one type of credit with another and/or substituting one form of credit for another, demand more study. Ideally, it should be possible to predict how consumers will view different forms of credit, an important challenge as the variety of loan products increases.

Regulatory action. In adopting regulation of any particular credit product going forward, the CFPB should attempt to anticipate how consumers might react by using alternate products. Ideally, the Bureau should ensure that regulatory action with respect to any single credit product also addresses potential substitute or complementary products, to ensure that bad practices by one lender or set of lenders do not survive in another loan context, leaving consumers as vulnerable as they were in the first market. placing restrictions narrowly targeting a single market without understanding consumer and supply responses more broadly may perversely harm consumers.

Can Disclosures Be Made More Useful (or Maybe Useful at All)?

Jeff Sovern

Executive Summary

Consumers largely ignore most disclosures. But some evidence suggests consumers do pay attention to some disclosures (e.g., single-letter grade health department ratings of restaurants posted on restaurant doors). The CFPB should study how consumers respond to online disclosures to determine what factors, if any, increase the likelihood that consumers will attend to disclosures, and use that information to design disclosures that will be more useful to consumers.

Problem

For better or worse, "mandatory disclosure has emerged as a dominant method of legal regulation in the United States." See Mathew A. Edwards, The Virtue of Mandatory Disclosure, 28 NOTRE DAME J. L. ETHICS & PUB POL'Y 47, 47 (2014). For example, many loans to consumers are not subject to usury laws. Instead, we often rely on the Truth in Lending Act's interest rate disclosures to tell consumers whether a loan is too expensive. TILA includes among its purposes assuring "a meaningful disclosure of credit terms so that the consumer will be able to . . . avoid the uninformed use of credit . . . ." 12 U.S.C. § 1601(a).

Society devotes considerable resources to prescribing and complying with disclosure laws as well as litigating whether particular disclosures satisfy applicable laws. Yet nearly all available evidence indicates that consumers largely ignore required disclosures. See generally Omri Ben-Shahar & Carl E. Schneider, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014). Even many consumer law professors don't bother to read required disclosures. See Jeff Sovern Another survey of consumer law professors fails to find any who always reads consumer contracts before signing them, CONSUMER LAW & POLICY BLOG, https://pubcit.typepad.com/clpblog/2019/06/another-survey-of-consumer-law-professors-fails-to-find-any-who-always-reads-consumer-contracts-befo.html (June 17, 2019).

But some disclosures may have been effective. An example may be the single-letter restaurant health grades (A, B, C, etc.) that some states and municipalities insist be displayed at restaurant entrances, see Ginger Zhe Jin & Phillip Leslie, The Effect of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards, 118 Q.J. ECON. 409 (2003), though even that success has been questioned. See Daniel E. Ho, Fudging the Nudge: Information Disclosure and Restaurant Grading, 122 YALE L. J. 574 (2012). Similarly, some evidence suggests that some consumers use calorie disclosures, though not always in the intended ways. See Christopher Berry, Scot Burton, Elizabeth Howlett, and Christopher L. Newman, Understanding the Calorie Labeling Paradox in Chain Restaurants: Why Menu Calorie Labeling Alone May Not Affect Average Calories Ordered, 38 J. PUBLIC POL'Y & MARKETING 192 (2019).

Given that the only protection consumers receive as to many aspects of transactions consists of disclosures, it is obviously desirable to have the best possible disclosures. Accordingly, Congress mandated that the Bureau validate its model forms through consumer testing. See 12 U.S.C. §5532(b)(3). Even before Congress enacted that provision, regulators had begun testing various forms of disclosures on consumers to see if consumers can understand them. See, e.g., Macro Int'l, Inc., DESIGN AND TESTING OF EFFECTIVE TRUTH IN LENDING DISCLOSURES: FINDINGS FROM EXPERIMENTAL STUDY (2008), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20081218a8.pdf. But measuring whether consumers who bother to read disclosures can comprehend them is only half the job of creating "meaningful disclosure[s that] avoid the uninformed use of credit" when consumers ignore many disclosures. Nothing in §5532(b)(3) limits "consumer testing" to testing consumer *understanding* of disclosures. In other words, if the Bureau wants useful disclosures, it needs to expand its testing regimen.

The Bureau can best achieve TILA's purposes by testing how consumers *use* disclosures in making decisions. If we want disclosures that help consumers make informed decisions, we need to know much more about how consumers behave in the moments when consumers are actually deciding whether to, for example, take out a loan. We need to determine the circumstances in those moments—including the types of disclosures, if any--that will cause consumers to read and take into account what a disclosure tells them. Fortunately, the march of technology has increased the ability to do just that.

In the recommendation section, I discuss ways the CFPB can learn more about how consumers respond to disclosures in real time.

Recommendations

Disclosures are increasingly provided to consumers online. See, e.g., Regulation F, 12 C.F.R. § 1034(b)(4) (indicating that debt collector's validation notice may be provided electronically). Indeed, it is now possible to obtain loans on a mobile phone. See, e.g., PayDaySay, https://paydaysay.com/loan-by-phone.php. The electronic delivery of disclosures enables web site operators to determine how long consumers have a particular screenful of text open on their screens and possibly to track in other ways how consumers use the information. Even if all the Bureau can determine is how long consumers have a particular disclosure open, that should enable the Bureau to ascertain whether consumers had enough time to read the information. The longer that consumers, on average, spend with a particular disclosure on their screen, the greater the likelihood that they are taking in the information. Cf. Florencia Marotta-Wurgler, *Does Disclosure Matter? NYU Law and Economics Research Paper No. 10-54,* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1713860 (2010) (study of clickstream data found that only .5% of consumers read End User License Agreements for at least one second).

I can think of two ways the Bureau can obtain this information but there may be others. First, the Bureau can purchase the information from commercial vendors. The Bureau has purchased data from vendors at least 31 times. See CFPB, SOURCES AND USES OF DATA AT THE BUREAU OF CONSUMER FINANCIAL PROTECTION 24-26 (2018). A downside of purchasing data is that such purchases would be limited to data that exists or can be generated from existing disclosures and would not enable the Bureau to test possible alternative disclosures.

A second possibility would permit the Bureau to design and compare different disclosures. Section 5532(e)(1) authorizes the CFPB to permit covered persons to conduct trial programs "for the purpose of providing trial disclosures to consumers that are designed to improve upon . . . model form[s] . . . ." Thus, the Bureau could work with lenders, for example, to provide different disclosures to different consumers for the same types of loans, and then determine how consumers responded. The CFPB could even work with multiple lenders and see if particular types of disclosures caused consumers to choose one lender over another. By providing the disclosures online, the CFPB could again discover how much time consumers spent with one disclosure or another. Similarly, the Bureau would also be able to tell if consumers responded to disclosures by clicking on some items to obtain more information. If the Bureau wanted to determine if a single-letter grade influenced consumers—as to which time spent on a web page might not indicate very much, given how little time is required to read a single letter--it could formulate criteria for such grades, show consumers disclosures with such grades, and then see if consumers respond by choosing the loan with the A grade or a lower grade. In any event, the Bureau should use the resources available to it to learn what it can about how to make disclosures useful to consumers.

If we learn, for example, that the only effective disclosures are those boiled down to a single letter grade, as with restaurant disclosures, law-makers could respond by supplementing or replacing existing disclosures with a single letter grade, to the extent that that is possible. If, on the other hand, we learn that consumers disregard disclosures no matter how they are designed, that would lend force to the argument that disclosures should be replaced with more effective regulation.

Regulating Overdraft

Lauren Willis

Executive Summary

We know overdraft fees are not competitively priced, are difficult to foresee and calculate, and are costly for vulnerable consumers. However, we have limited data on: (1) what consumers know when they agree to overdraft coverage and when they incur the fees, and (2) the consumer welfare effects of overdraft coverage. Given the imminent abandonment of these fees by several banks, ***now*** *is an opportune time to assess consumer financial health with and without access to overdraft. Lessons learned from overdraft research also could inform policymaking regarding nontransparent prices generally.*

Problem

The evidence we have suggests that overdraft, like other contingent financial product fee structures, is not fully transparent to consumers. Further, as with other forms of high-priced credit, the net welfare effects of overdraft coverage on consumers are uncertain.

At account opening, consumers can be confused about what they are agreeing to. Few (if any) consumers can calculate the amount of overdraft fees they are likely to pay based on their future account usage, the timing of future income and expenses, and the vagaries of deposit clearance timing and transaction re-ordering. Lack of transparency at account opening is one obstacle to price competition.

When consumers take actions that trigger overdraft fees, some do not know they will incur fees and many do not know—and in some instances could not possibly calculate—the fee amounts. Lack of transparency at the time the fees are incurred prevents consumers from making fully informed decisions about their own spending and from shopping for cheaper sources of credit. The fees may feel exploitative, burdening consumers when their bank accounts are empty, lowering their trust in the market and its regulator.

Overdraft fees are incurred primarily by a disproportionately low-income segment of accountholders, and some evidence also suggests a disparate racial impact. These fees may be a regressive cross-subsidy to higher-income consumers, if not simply rents transferred from low-income consumers to financial institutions. For frequent overdrafters, the amount of fees paid can be substantial relative to their incomes. Unexpected fees are particularly harmful to these consumers, who have little slack in their budgets.

The current regulatory regime for overdraft—a combination of disclosure and a no-overdraft default rule—has not made these fees transparent to users. The regime does not attempt to address the possibility that the costs of overdraft coverage exceed its benefits to consumers. Arguably, the regime has backfired, making consumers blameworthy for their own plight because they have “chosen” overdraft coverage.

Recommendations[10]

Research Stream A. A **time-sensitive research project** would use the imminent abandonment of overdraft fees promised by several financial institutions as a natural experiment to assess the consumer welfare effects of overdraft. The financial health of a random sample of accountholders who have incurred overdraft charges in the past year at these institutions (and a control group) could be assessed before—and again six or twelve months after—the institution discontinues overdraft. Financial health might be assessed through surveys, credit scores or credit reports, for example.

Should data collection not occur prior to the discontinuation of overdraft, accountholders who previously incurred overdraft fees could be queried to discover any detriment or benefit they believe they experienced as a result of the loss of overdraft coverage. Alternatively, financial health could be compared as between accountholders at institutions that rely heavily on overdraft and at institutions that do not offer overdraft, controlling for other differences in the two populations.

Regulatory Action A. Should these surveys reveal negative effects on consumer financial health that are likely attributable to overdraft, that could form the basis for restrictions on overdraft fees under Dodd-Frank § 1031[11] as a rule to prevent the offering of an unfair and abusive product. For example, financial institutions might be permitted to charge no more than one overdraft fee to an accountholder in any calendar month, the amount of which cannot exceed the lesser of $25 or the amount by which the account was overdrawn. This tracks the CARD Act's successful treatment of over-the-limit fees[12] and leaves in place potential access to an emergency overdraft loan once per month, encouraging accountholders to save it for a rainier day.

Research Stream B. Assessing the effectiveness of current regulation would require testing consumers for knowledge about overdraft coverage when they consent to it and about the fees they will incur when they take an action that triggers fees. Researchers would need to work with financial institutions to recruit accountholders immediately after they agree to overdraft coverage and immediately after they take an action that triggers overdraft fees. For researchers to assess the accuracy of consumer knowledge, institutions would need to disclose what triggered the fees and the amount of the fees.

Regulatory Action B. Should overdraft be nontransparent to consumers who incur these fees, that could form the basis under Dodd-Frank § 1032[13] for rulemaking "to ensure that the features of any consumer financial product . . . , both initially and over the term of the product . . . , are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product . . . in light of the facts and circumstances."

For example, institutions might be required to demonstrate, through periodic random sample audits of their accountholders who incur overdraft fees, that these consumers know the terms of coverage when they agree to it and know the existence and amount of fees when they incur them. If too large a proportion of an institution's customers are confused, the bank might be required to disgorge all overdraft

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[10] These research proposals could involve surveys. The Bureau could perform these with OMB approval (potentially with emergency processing to enable action prior to an institution's abandonment of overdraft) or possibly under the Paperwork Reduction Act's knowledge testing exception. Alternatively, the Bureau might offer grant funding to academics to assess the efficacy of current overdraft regulation in ensuring consumer knowledge about overdraft and promoting consumer welfare, leaving it to grant recipients to choose how to measure these. In addition, members of Congress could ask the GAO to study the effectiveness of current overdraft regulations, with respect to both consumer financial health and consumer understanding (as GAO has done for 401(k) plan fees).

[11] Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2005 (2010) (codified at 12 U.S.C. § 5531).

[12] Pub. L. No. 111-24, 123 Stat. 1734 (2009) (codified at 15 U.S.C. § 1601 et seq.).

[13] Pub. L. No. 111-203, § 1032(a), 124 Stat. 1376, 2006–07 (2010) (codified at 12 U.S.C. § 5532(a)).

fees charged to accountholders over the prior period. A second possibility would be to require institutions to obtain affirmative real-time consumer consent to a specified amount of overdraft fees at the moment they incur the fees. These confusion audits or real-time consent obligations could be trialed and refined as part of consent decree remediation plans in cases involving overdraft.

If successful, similar regulatory strategies could be employed to address other products with opaque pricing structures.