CONSUMER PROTECTION DRIVES FINANCIAL HEALTH

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In the wake of the financial crisis, consumer protection regulation has focused principally on preventing financial services organizations from doing affirmative harm. That's an excellent start, but going forward, consumer protection can and should help the industry accomplish its best and highest function: making the lives of American families better and more stable through finance.

FIRST, DO NO HARM

Consumer finance can make life better. Much better. For most American families, and especially for those with low or middle incomes, the right financial products delivered at the right time and at the right price can enable happiness and material comfort in both the short- and long-term. The right insurance can provide both peace of mind and financial protection from life's occasionally tragic twists and turns. The right investments can ensure a comfortable and independent retirement. The right mortgage can help a family put down roots and build wealth for future generations. The right student loan can open the door to a brighter future. The right line of credit can absorb a myriad of minor financial mishaps.

Unfortunately, for too many families, both before and during the financial crisis, consumer finance didn't make life better. It actually made life worse. Families of modest means bought into the American dream of homeownership, but at the cost of obligations they had no real shot of ever paying back. Too many students borrowed ever-larger sums to finance educations with dubious financial value. Millions of Americans living paycheck to paycheck covered small but frequent cash shortfalls with hugely expensive overdraft and payday products.

Given that shabby recent track record, it is no surprise that the most energetic recent legislative and regulatory interventions have focused on alleviating the worst of these outcomes and the most pernicious of the industry's bad practices.

The Credit Card Accountability Responsibility and Disclosure Act of 2009 (the CARD Act), for example, has nearly eliminated the faintly ridiculous practice of allowing cardholders to charge a few dollars over their limits, but then immediately slamming them with a $39 fee for the privilege. Gone as well is the practice of hooking customers at a teaser rate, only to turn around and raise prices.

Dangerous practices in the mortgage market have been curtailed as well. The Dodd-Frank Act and the new Consumer Financial Protection Bureau (CFPB) have eliminated the scandalous "liar loans" that helped inflate a massive housing bubble and trigger a global financial crisis. Critically, lenders are now required to actually inquire into and confirm a borrower's ability to repay a loan.

As important, the CFPB has, for the first time, the authority to extend meaningful federal supervisory jurisdiction over more than just banks. That means that the kind of structural "conduct arbitrage" that has long plagued the industry—wherein the sketchiest and sharpest of practices, when prohibited in closely supervised banks, migrate to federally unsupervised non-bank finance companies—has become much more difficult. To date, the CFPB has extended federal supervision (including examinations) to non-bank payday lenders, non-bank mortgage companies, private student lenders, debt collection firms, automobile financing and credit bureaus. Other nonbank sectors will follow. At the same time, an energized and aggressive CFPB enforcement arm has identified and shut down scam artists and fraudsters. Even if a firm avoids the CFPB's direct supervision, the Bureau's enforcement authority can still root out unfair, deceptive, or abusive practices.

By putting an end to some known harmful practices and making it much harder for new ones to take hold, the current consumer protection regime can help ensure that financial products, like good physicians, "first, do no harm."

ENABLING MARKETS THAT SERVE CONSUMERS

These regulatory changes, including enforcement actions, are giant steps in the right direction. Not only have they helped stamp out the potential for consumer harm, but they have also set the table for a marketplace that can help consumers live better lives.

First, an assertive approach to consumer protection is preventing bad practices from crowding out good practices in the marketplace. Consider the example of the broad repricing of credit card teaser rates, which was relatively common before the CARD Act. Teaser rates created real consequences for consumers given that cardholders would sign up for one rate but soon pay a much higher rate without realizing it. This practice also prevented more transparent products from succeeding. When one lender is marketing a deceptively low teaser rate, and another lender is marketing a more accurate, but higher rate, the consumer will likely opt for the lower rate. That means the honest lender will end up with substantially higher marketing costs, which can be crippling. Even worse, the honest lender can suffer “adverse selection” in credit performance. Those borrowers who choose a higher headline rate are not necessarily savvier about teaser rates. Often, the opposite is true. They don’t care about price because they do not intend to pay the lender back anyway. That means higher credit risk, on average, which when combined with higher marketing costs is a business killer.

Consumer protection enables a better market in another way: it builds (or perhaps rebuilds) consumer trust in financial services and institutions. Consider the remarkable rise of prepaid debit cards among the underbanked as a substitute for traditional checking accounts. In no small measure, growth in that market stems from a perceived simplicity and transparency compared to “free checking” products that were fueled by repeat overdraft fees. Customers’ trust tends to decline when their main interaction with a product is through penalty fees or other unknown or unclear backend charges. By contrast, many of today’s prepaid products are considerably more straightforward, with fewer chances for unexpected fees. With time, and especially as the CFPB takes regulatory steps to ensure its continuation, that reliability and predictability can build trust in a product, in a franchise, and even an industry. That in turn can help families confidently live better and healthier financial lives.

ACCELERATING CONSUMER-FRIENDLY INNOVATION

A renewed and re-energized emphasis on consumer protection is already helping the market function better. But by tailoring the administration of that consumer protection regime we can do even more: we can accelerate and catalyze consumer-friendly innovations in financial services.

Stubborn problems in consumer finance, such as how to provide affordable credit options to customers with limited ("thin") credit files, are stubborn for a reason. The problems are not solvable using traditional products, underwriting techniques, or channels. But technological developments are leading to breakthroughs, such as building up those thin files with more data from nontraditional sources, or lowering distribution costs through seemingly ubiquitous mobile devices. Consider the decision-making advantages of machine learning algorithms set to work on non-traditional "big data" sources; consider the cost and speed advantages of a clearing and settlement system based on open source distributed networks.

The challenge, though, is that these technological innovations frequently fall into interstices in the latticework of consumer protection regulations. The resulting uncertainty can stymie the development of new and better products, and, paradoxically, encourage innovation by only the most cavalier entrepreneurs, who build a product first, and figure out the pesky regulatory issues later.

This is unfortunate but not surprising. Consumer protection regulation is much like other forms of regulation; it was constructed over many years to solve problems that were, at the time, urgent and important. Given the particular American legal penchant for clarity and certainty, it tends to solve those problems with hyper-technical and finely detailed rules. Those rules, in fact, do tend to protect consumers interacting with large, existing businesses that use traditional technologies and business practices. But an approach that eschews general principles in favor of specific rules developed with elaborate administrative rule-making processes is inherently bad at anticipating or responding quickly to technological innovation.

Acknowledging this inherent weakness, we can foster innovation through other, nontraditional regulatory mechanisms. Doing this well will require that regulators embrace three new habits.

1. **Engage.** Regulators cannot enable innovation if they don't know where the innovations are. Regulatory time and attention, at the CFPB and elsewhere, is quite legitimately concentrated on the largest institutions, the most expansive business lines, and the most pressing problems. But doing so risks missing new solutions to big problems. Like everyone else, regulators have finite resources and it makes sense to focus on big, existing issues rather than looking forward to future possibilities. But by doing that, regulators can fall prey to the same incumbency bias that afflicts most large organizations.

   To combat that quite natural bias, regulators should specifically and affirmatively engage with entrepreneurs, small firms, and investors who might be dramatically smaller than typical regulatory charges.

2. **Assert principles early.** Even "independent" regulatory agencies are subject to political and media pressures. But it is critical that agency leaders not let those pressures result in a paralyzing risk aversion to innovation and change. An agency need not solve every policy detail relating to a new technology before developing and sharing broad principles about substantive fairness and transparency. To be sure, a regulator who develops points of view in fast-moving and dynamic markets will, with some frequency, get things wrong. But it is only in being willing to be wrong (and humble enough to admit mistake and adjust) that regulators can support entrepreneurs who are trying to do right. That same willingness to assert principles early can also stop, or at least slow down, harmful practices before they spread.

3. **Make exceptions.** Many federal statutes carry surprisingly broad exemption authority, or provide, as a practical matter, considerable regulatory discretion on how to administer statutory mandates. Regulators should use that discretion to relieve regulatory constraints for low-risk pilot programs. Most new ideas do not work on their first iteration. It is only through rapid testing and tinkering that breakthroughs happen. Freighting new programs with industrial-scale compliance requirements impedes rapid testing and tinkering, and therefore

inhibits breakthroughs. Finding ways to aggressively wield exemption authority, while monitoring for potential risk, is an underdeveloped regulatory skill.

Consumer protection regulation in its more assertive, post-crisis formulation has already righted wrongs. But spurring transformative innovation—the kind that can make breakthrough improvements in families' financial lives and stability—is as important a goal as preventing abuse. It is not enough for consumer finance to do no harm; it should make life better. And smart regulation can help.

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