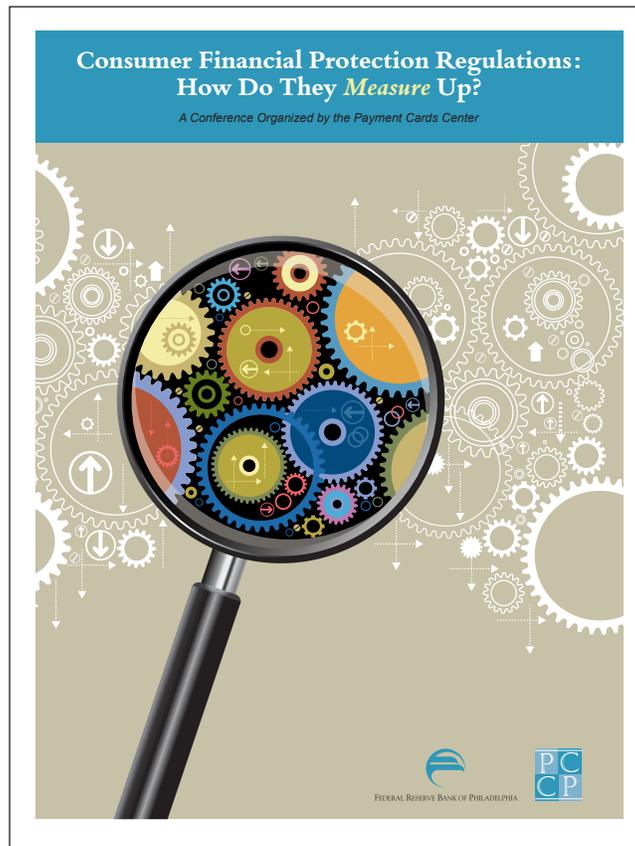


CONFERENCE SUMMARY



Consumer Financial Protection Regulations: How Do They *Measure Up*?

Role of Measurement in the Design
and Assessment of Consumer Financial Protection Regulations

September 13–14, 2012



FEDERAL RESERVE BANK OF PHILADELPHIA

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Role of Measurement in the Design and Assessment of Consumer Financial Protection Regulations

Dubravka Ritter*

Summary

The Payment Cards Center's September 2012 policy conference advanced the discussion of targeted design and outcome measurement as central features of public policy in the area of consumer financial protections. Speakers considered regulations addressing the disclosure of credit terms; standards for assessing the unfairness, deceptiveness, and abusiveness of lending acts or practices; the management of revolving credit accounts; and the challenges of analyzing consumer complaints in the context of consumer financial protections. The concluding panel discussed unanswered questions and research priorities going forward. Discussion focused on the data and methodology required and available for assessing the contribution of consumer financial protections to the advancement of, and the challenges inherent in, measuring social welfare. Panelists also considered the intended and unintended effects of these regulations on prices, quantities, competition, innovation, and the overall business risk market participants face.

Keywords: measurement, consumer financial protection, disclosure, UDAP, UDAAP, account management, mortgages, credit cards, consumer complaints

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* Payment Cards Center, Federal Reserve Bank of Philadelphia, Ten Independence Mall, Philadelphia, PA 19106;
e-mail: dubravka.ritter@phil.frb.org

**TABLE OF
CONTENTS**

I. Background and Introduction	5
II. The Evolution of Consumer Financial Protections	5
III. Revisiting Disclosures	9
IV. Unfair, Deceptive, or Abusive Acts and Practices	12
V. Changes to Revolving Accounts	14
VI. Consumer Financial Protections and Consumer Complaints.....	19
VII. Recurring Themes and Conclusions.....	22
Appendix A — Glossary of Key Terms.....	25
Appendix B — Key Laws and Regulations	26
Appendix C — Bibliography and Related Publications	28

I. Background and Introduction

The Payment Cards Center (PCC) of the Federal Reserve Bank of Philadelphia hosted a conference September 13–14, 2012, that focused on the practical application of measurement in analyzing the markets for consumer credit, with a particular emphasis on regulations that are intended to protect consumers in these markets. Recognizing that many businesses and agencies today increasingly gather, analyze, and respond to large volumes of data in many aspects of their operation, the conference was intended to discuss the role that measurement and scientific method can or ought to have in the design of consumer financial protection regulations and in the analysis of such regulations' effects on the markets.

In his opening remarks, Robert Hunt, vice president at the Federal Reserve Bank of Philadelphia and director of the PCC, noted that individuals and groups both inside and outside the Federal Reserve System have long been thinking about many of the issues touched upon during the event. But two developments over the past several years warranted a fresh look at this important topic. The first is the availability of new technology and techniques that enable us to collect and analyze increasingly large amounts of data and to use measurement to advance our understanding of the world. The second is the establishment of the Consumer Financial Protection Bureau (CFPB) as the federal regulatory agency primarily responsible for the design and implementation of consumer financial protection regulations at the federal level. The goal of the conference was to outline a well-functioning feedback loop between an analysis of behaviors and outcomes in a market, a (potential) policy response to outcomes observed in the market, an understanding of how the market adapts to such a policy response, and a (potential) refinement of the policy instrument itself.

The event brought together representatives from various market participants (banks, payment card networks, law firms, and consulting firms); federal regulatory agencies; academia; and consumer advocacy groups to have a candid discussion of the objectives for a given regulation and of how the protections, as they are implemented, affect the targeted activities and the market itself. The event consisted of six panels, each comprising distinguished representatives from the vari-

ous stakeholders previously described. The discussion at the conference, as in this synopsis, was organized around the life cycle of a credit relationship between a lender and a consumer, and each of the panels focused on a stage in this life cycle.

The introductory panel set the scene for the remainder of the event by considering the overarching philosophy and principles that underlie consumer policy, as seen through the prism of federal consumer financial protection laws enacted from the 1960s to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Subsequent panels addressed federal laws and regulations that govern the information exchange with consumers who are searching for credit; the potentially unfair, deceptive, or abusive acts and practices (UDAAP) when the consumer is selecting a product; the conduct of financial services providers during the account management stage of a renegotiable contract; and the collection, analysis, and publication of consumer dissatisfaction metrics (such as consumer complaints). The conference concluded with a discussion of the data and research resources needed to effectively evaluate consumer financial regulations in the future along with ways in which insights from this conference may help policymakers improve the efficacy and cost-effectiveness of regulations going forward.

This synopsis summarizes the discussion at the conference by outlining the key insights presented by conference participants and by reviewing the key themes from the event. The conference was successful in stimulating robust and candid discussion; this summary highlights the areas of agreement and disagreement from this discussion, without taking a position on the issues. For more detailed information on particular panels, some of the speakers' presentations are available on the PCC's web pages.

II. The Evolution of Consumer Financial Protections

The United States has seen — at the federal level alone — 40 years of crafting, enforcement, and evaluation of consumer financial protection regulations. Speakers on the first panel of the conference set out to ground the discussion for the rest of the event in that experience by addressing five broad questions that highlight the main (and sometimes conflicting) concepts

and principles underlying consumer financial policy. Focusing not on any specific current piece of legislation but looking back over the history of consumer protection regulations, they contemplated some of the overarching questions that should be discussed before considering the role of measurement and scientific method as elements in a regulator’s toolkit.

A. Regulation as a Zero-Sum Game

The panel first considered whether consumer protection regulation of the financial services industry is a zero-sum game (in that regulations that help consumers hurt industry, and vice versa), an idea that all speakers readily rejected. Travis Plunkett of the Consumer Federation of America (now at The Pew Charitable Trusts) pointed out that, while all regulation imposes some cost, “inattention to consumer problems also imposes costs.” Urging conferees to avoid the sort of simplistic arguments often heard in debates about regulation, Plunkett noted that regulatory analysis is typically better at identifying costs (usually costs to regulated entities) than it is at evaluating long-term effects on the financial health and security of both families and financial institutions that result from regulation. Instead, analysis of the effects of regulation should be broadened to take into account not only the cost of regulation but also the cost of no regulation; viability of alternative regulatory approaches, such as disclosure; effects on product availability and choice; unintended consequences related to product substitution; changes in the market resulting from regulation; effects on small institutions; and other factors.

Speaking from an economist’s perspective, Michael Staten of the University of Arizona likened binding regulation to imposing constraints. He argued that virtually no binding regulation leaves the proverbial pie intact, but rather, it either increases or decreases the size of the pie. He argued that the objective should be “to protect consumers from harm but encourage enough entry and competition, better and more products” to expand opportunities and avoid the long-run exit of either consumers or firms from the market due to onerous regulation. Staten provided two examples of developments that illustrate increases in the size of the pie. The first was the adoption of risk-based pricing that expanded access to unsecured credit for some consumers while encouraging lenders to compete to serve those

consumers. Staten argued that such an outcome could not have occurred in an environment with very low interest rate (usury) ceilings. The second was the adoption of a “positive” credit reporting system in the U.S. While such a system is often characterized as protecting consumer privacy and reputation, research has shown that it also expands access to credit.¹

Robert Avery of the Federal Housing Finance Agency (and formerly of the Federal Reserve Board of Governors, or the Board) suggested the nature of the regulatory debate often depends on whether the product or practice in question is an established one, or one that is very new. In the latter case, regulators may be forced to deal with hypotheticals, as there is little data available in order to measure costs and benefits. In those cases, the analysis may necessarily fall back to a discussion of the interests of different groups. Avery also pointed out that neither consumers nor lenders are homogeneous groups. Most regulations affect well-being differently within both groups, so one cannot simply examine aggregate outcomes for consumers and industry in crafting or evaluating regulations.

B. Regulating Information Versus Product Features

Next, the panel considered the tension between two differing views of regulation: one that focuses on information and disclosure and another that focuses on explicit regulation of contract features. The latter is sometimes accomplished via specific legislation. More often, it occurs when a specific act or practice is determined, by a regulator or a court, to be unfair, deceptive, or both.² This typically requires establishing substantial harm that is difficult for the consumer to avoid or mitigate.

Staten discussed the role of regulation as responding to some degree of market failure by “encouraging sellers and buyers to internalize the cost of their activities so as to increase the net benefits to exchange.” In

¹ Positive credit reporting is the practice of including in credit bureau files information about the consumer’s credit accounts that are in good standing. In some other countries, only derogatory information (e.g., delinquent accounts) is included in credit bureau files. For evidence of the value of positive credit information, see Barron and Staten (2003).

² Precise definitions of these terms are found in Appendix A.

Staten's view, this can be accomplished with four major tools: 1) competition in markets, 2) sufficient information disclosure to consumers, 3) tort liability (so sellers will internalize the potential risk or harm they may be imposing on the consumer), and 4) explicit regulation of product features.

Staten argued that tort liability has played a significant role in weeding out unsafe consumer goods, but it has rarely been applied to credit products because the interests of the lender and the borrower with respect to the ability of the consumer to repay the loan are inextricably linked.³ In Staten's view, barring examples of disconnect between loan losses to the lender and the actions of the lender (as existed in the mortgage market during the recent crisis), the nature of the credit market is such that "the suitability issue ... fades in comparison to the lenders already being incented to evaluate the ability to pay." Consequently, explicit limitation of product features to reduce unfair or deceptive advertising may make sense, but the market structure may already effectively induce lenders to internalize the costs of their actions.

Avery focused on the complexity inherent in selecting the criteria one might use to determine which acts or practices merit an outright ban and on the measurement tools and evidence regulators might need for such an analysis. For products with long lives, such as 30-year mortgages, evidence that there may be a problem is slow to arrive, so regulators may look at up-front product pricing instead. Even in that case, Avery pointed out that judging what constitutes an "inappropriate" price raises additional challenges. The difficulty in determining the sufficient hurdle in terms of prevalence (sometimes referred to as a "pattern of practice") is compounded by an inconsistent availability of data necessary to measure a practice's effect, and both complicate the classification of a practice as unacceptable. This leaves a third option: namely, judging a practice on its face. However, even when that may be warranted, Avery recommends using evidence behavioral economists might produce: namely, experiments and

³ On the other hand, the adoption of mandatory arbitration clauses in contracts for consumer credit may reduce the effectiveness of class-action lawsuits as an ex-post remedy. The benefits and costs of class-action lawsuits, as well as mandatory arbitration, are frequently debated, but they were not a major focus of this conference.

focus groups that may suggest that consumers would be misled before a proposed practice is even implemented.

On the other hand, Plunkett argued for a step-by-step approach in arriving at "measured, targeted, substantive regulations based on documented abuses." The first step would involve using the tools from disclosure regulations and considering whether robust disclosure requirements provide a solution. In doing so, he argued that we must recall that disclosures in the mortgage and credit card markets did not help consumers avoid sustainability issues in their borrowing in the past.⁴ Plunkett argued that focus group evidence shows that many consumers did not understand a number of complex, and not uncommon, practices in the credit card market (prior to the enactment of the Credit CARD Act of 2009 (CARD Act)).⁵ For mortgages, Plunkett argued the process can be further complicated by the influence of real estate agents or mortgage brokers, whose incentives may not be aligned with those of the lender or consumer. He also pointed to research suggesting that consumers often shop for credit primarily on the basis of a limited number of contract terms.

Under circumstances such as those previously described, Plunkett posited that disclosures may not be a very effective tool for facilitating competition and weeding out practices that may harm consumers. Regulators may then have to resort to other tools to determine which practices may be inappropriate (e.g., by relying on UDAAP-type guidelines or on a consideration of the product features) as Avery discussed.

On the other hand, Staten mentioned there are studies suggesting that consumers do respond to fees either by ceasing the behavior that caused the fee or by switching to a credit card that does not impose the same level of fees. Staten argued that the market may not be great at preventing harm to the first consumer, but it can ensure that the pattern does not continue

⁴ Plunkett further argued that sustainability should be added as a major policy goal alongside Staten's credit availability and reasonable prices.

⁵ Plunkett mentioned the practice of applying a consumer's monthly payment to balances incurring the lowest interest rates (such as a balance transfer) before paying down balances incurring higher interest rates. The CARD Act includes language that prohibits such practices.

with (many) subsequent consumers. In addition, Staten pointed out that smaller institutions, such as credit unions, may not be large participants in terms of market share of debt balances, but they can nevertheless impose some pricing discipline on the larger institutions.

C. Regulation and Competition

The panel continued with a discussion of the role that competition plays or has played in assessing the need for regulation. Avery contemplated whether competition primarily serves to protect consumers, or whether competition in markets with low margins may result in negative effects on consumers because lenders may have little choice but to find ways to “fool” consumers or be pushed out of the market, engaging in what is commonly referred to as a “race to the bottom.” Providing examples for each of the propositions, he argued that “understanding the competitive risk of markets is central to how you would approach rulemaking.”

“Understanding the competitive risk of markets is central to how you would approach rulemaking.” — Robert Avery, Federal Housing Finance Agency

Noting that the consumer community generally approaches competition as positive, Plunkett stated that regulatory policy can nevertheless be used to drive competition on price. Prior to the CARD Act, he argued, issuers competed on fees instead of initial contract pricing, which created incentives to shroud the true costs of a credit card or to exploit cognitive biases of consumers. Regulations stemming from the CARD Act outright prohibited many contentious practices in credit card account management, which has led to more competition on upfront benefits and upfront costs — developments Plunkett views as positive.

Staten reiterated that so long as there is an information feedback loop — an opportunity for consumers to learn from others and from their own experience — there will always be a pricing premium for a lender who provides the consumer with a better deal, so the benefits of competition will be preserved. He rejected the idea of a “sweat box” model in lending, at least in the long run, and provided recent examples where positive

innovation from credit card issuers exemplifies competition. Plunkett countered that such examples do exist but suggested they have been more prevalent after the CARD Act, concluding that regulation forced competition on more positive grounds. Staten further argued that regulatory intervention can raise barriers to entry and thus reduce competition. Plunkett responded, suggesting that public policy should be willing to accept somewhat higher barriers to entry in instances where regulation is necessary to improve the offerings available to consumers.

D. Level of Regulation

The panel disagreed to some extent on whether local (state) credit markets still exist in discussing whether consumer financial protection regulations should be designed and enforced at the state or federal levels. Staten argued that lending is a sufficiently national market and that there is no need for further

state regulation, likening passing the regulatory torch to state level regulations to a punt. On the other hand, Plunkett noted that local markets do remain (such as for certain car loans), that states are often the “first responders” before regulations reach uniformity, and that it

is not a good idea to “abandon more than 100 years of regulation of some of these marketplaces in the name of a theory ... that we should only have federal regulation.” He further argued that some level of regulatory redundancy (as distinct from joint enforcement) from a consumer protection point of view may lead, in fact, to better outcomes in the marketplace and need not be frowned upon.

E. Consumer Protections and Safety & Soundness Regulations

Prior to the advent of the CFPB, a regulator focused solely on consumer protection regulations, and U.S. banking regulatory agencies had to balance consumer protection and prudential regulation under the same roof. Staten argued that such a balancing act is simply not possible, citing operational problems that arose both from subordinating prudential to consumer protection regulation in the United States and from doing the opposite in other countries. Avery concurred

but argued that some synergy stemming from “multiple eyes on the problem” in the form of several examiners or even agencies examining the same set of business practices may be lost if prudential and consumer protection supervision are separated. He argued that this may be a particular issue in cases where prudential examiners are — by the nature of their job — better versed in the lender’s business practices than consumer protection examiners. Plunkett was more skeptical, wondering which synergies may exist that do not occur with the CFPB in the supervisory function, with suitable attention paid to all of the areas pertaining to consumer protection on which a prudential examiner may focus.

III. Revisiting Disclosures

The Truth in Lending Act of 1968 (TILA) is the oldest of the federal consumer protection regulations. It is primarily a disclosure law, but it also has a few substantive requirements. The principal focus of TILA is on the exchange of information between a credit applicant and a financial institution in the shopping and product selection stages — from consumer inquiries to periodic outreach efforts that are expended in the search for new accounts.

In the second session, Gregory Elliehausen of the Board provided a detailed overview of credit markets before TILA, the ways in which TILA has succeeded in improving consumers’ understanding of terms and conditions, and the ways in which TILA may not have met expectations. Before TILA, methods for disclosing interest rates varied depending on the type of credit or lender. At that time, credit markets were much more segmented by geography and type of lender, with different lenders specializing in different areas in the spectrum of credit risk. Usury ceilings and other regulations enacted at the state level often varied by type of lender or loan, which complicated shopping across lender types. Few consumers were familiar with interest rates calculated on an actuarial basis, but available research suggested they often could perform some of the calculations for add-on rates and were aware of rate differences between institution types, loan amounts, and loan types. Levels of consumer shopping were similar to those of consumers today, so Elliehausen argued that consumers before TILA turned out not to have been

quite as uninformed about credit cost as their lack of familiarity with interest rates, calculated in terms of APR, might have suggested.

Nevertheless, there are advantages to mandated disclosures such as those found in TILA relative to regulating products or practices, Elliehausen argued. He suggested that information disclosures are generally “compatible with many forces already at work to protect consumers,” are relatively low cost, and are relatively simple to layer over existing regulations. Although the goals for TILA evolved and expanded over time, the law was broadly intended to enhance competition by driving out high-cost lenders, to improve awareness of credit costs, and to encourage credit shopping. Elliehausen pointed out that these goals sometimes conflicted with one another in terms of the level of detail in disclosures they implied.

Elliehausen noted some additional challenges in designing effective disclosures. For example, credit is often part of a transaction that consists of other components (e.g., an automobile purchased together with financing) so that the cost of the good and its financing are often jointly determined. Some disclosures “involve future outcomes that are contingent on unknowable future events” (for example, future interest rates). Some disclosures intended to provide guidance have resulted in unanticipated outcomes. He pointed to the example of a new disclosure mandated in the CARD Act that describes how long it will take a consumer to repay his or her credit card balance by making only the required minimum payments — some consumers increased their payments, but others began making only minimum payments.

Elliehausen observed that since the passage of TILA, consumer awareness of interest rates has increased. In 1969, 27 percent of cardholders were aware of the APR on their most frequently used bank card. In 2012, 84 percent of consumers were aware of this interest rate (similar trends have occurred for other types of consumer credit).

While consumers appear to be considerably more aware of credit costs, the available evidence suggests this information affects the behavior of some, but not all, consumers. Elliehausen referenced a study that found 35 percent of cardholders in 2012 indicated that the APR or finance charge information on their monthly statement affected their card use. This pro-

portion was higher for consumers with large balances or who sometimes or hardly ever paid their balances in full. In other words, consumers who are more likely to bear these costs also appear more likely to respond to them. Similarly, awareness of costs among cardholders is associated with paying off balances more quickly, switching from high-rate accounts, or limiting card use.

Ellehausen concluded that TILA may have improved availability of information generally, even if some of the information was complicated or not particularly helpful to consumers. He recommended that regulators keep a sharp focus on disclosure of credit costs (TILA's key goal), attempt alternate approaches if existing approaches do not appear to work, recognize that different goals (e.g., recordkeeping versus simplification) may require different approaches, take advantage of technology to help consumers process information, and remember that disclosure is no panacea.

John Driscoll of the Board provided an overview of some behavioral and cognitive biases that may hinder consumers' understanding of disclosures and sway their decisions. He began by describing a practice that is sometimes called "drip pricing." Drip pricing occurs when elements of a product's costs are revealed over time (i.e., drip by drip) rather than all at once. A prime example is a purchase of an ink-jet printer — the long-term cost of printing typically is in the ink cartridges, which are priced separately and whose cost is usually not advertised at the time the printer is purchased. Other common examples are car rentals and plane tickets, in which fees for insurance and bag charges are revealed at a point when consumers find it difficult to change their plans. Unsophisticated consumers typically are unable to avoid these shrouded charges easily, and such consumers effectively subsidize sophisticated consumers in equilibrium. Competition may not drive drip pricing away because firms have no incentive to educate unsophisticated consumers since

such consumers are profitable. Furthermore, Driscoll argued, the welfare effects of "debiasing" all consumers are unclear because sophisticated consumers may lose the benefit of cross-subsidies that are paid by unsophisticated consumers in the same market. He also suggested that evidence on the benefits of debiasing efforts as implemented by individual firms is decidedly mixed.⁶

Driscoll said there are some clear examples in which better disclosures have had significant effects. For example, publishing restaurant hygiene grades has reduced local hospitalization rates. But he also noted that evidence on the effects of disclosures in financial products is more mixed. For example, in a series of experiments, Choi, Laibson, and Madrian (2011) revealed that people do not invest in the lowest cost 401(k) funds with the same investment goals even

"Nothing in Truth in Lending compels consumers to read, understand, and respond to disclosures. About all that can be expected is that adequate amounts of credit cost information are available at appropriate times in more or less standardized vocabulary and in understandable formats, so the consumers wanting to use it can do so."

— Ralph Rohner, Professor of Law, Columbus School of Law

when full information sheets on investment costs are made available to participants. This is not to say that disclosure doesn't work in general, but there can be considerable implementation challenges, particularly when firms are not properly incented to reveal costs.

Driscoll then discussed consumer behavioral biases that may affect regulators' ability to implement mandatory disclosures. He discussed the concept of "framing," more commonly known as, "[I]t's not just

⁶ Driscoll presented the examples of Kodak, which made ink-jet printers by advertising cheap ink; clothing retailer Syms, which claimed educated consumers are its best customers; and Southwest Airlines, which has heavily advertised its lack of add-on fees. The first two firms were bankrupt at the time, but Southwest has enjoyed considerable success.

what you say, but how you say it,” best exemplified by the Schumer Box.⁷ Prior to the CARD Act, banks allocated payments to lowest-interest balances first. Driscoll’s research reveals that only about one-third of consumers (and an even lower percentage of young and elderly consumers) understood that to minimize interest payments when transferring a balance to a new card with a teaser rate, the consumer should incur no new spending on the card before paying off the balance transfer because any payments would be allocated to purchases made at the teaser rate and not the balance transfer. In this case, disclosing the balance transfer offer to consumers clearly and concisely was insufficient to optimize decisions because consumers did not understand payment allocation rules in effect before the CARD Act.

Driscoll also discussed the significance of “default options” in consumer finance. In this context, the term does not refer to credit risk but rather to the well-documented tendency of consumers to stay with the option they began with — even when they are subsequently exposed to information suggesting that an alternative option would likely be a better choice. Default “stickiness” may reduce welfare if consumers are defaulted into suboptimal options. At the same time, as Sunstein and Thaler (2008) have argued in their book, this behavioral tendency can also be used to raise consumer welfare if the default options are objectively “safe” or “good.”⁸

Next, Driscoll discussed his research on learning and forgetting with respect to credit card fees. With his coauthors, he finds that consumers who initially pay fees tend to avoid those fees in the future, which suggests there is a level of learning from experience (Agarwal, Driscoll, Gabaix, and Laibson, 2008).⁹ But this learning may be subject to depreciation. They find that while paying a fee this month will reduce the likelihood of paying a fee next month, it has no effect

⁷ The Schumer Box is a summary of the costs of a credit card, named after Senator Charles Schumer.

⁸ Identifying default options that are objectively “safe” or “good” presents a considerable challenge, particularly for complex credit products.

⁹ See also Stango and Zinman (2009).

on the consumer’s likelihood of paying a fee a year from today. Driscoll suggested that consumers may benefit from disclosures that are repeated at a certain frequency.

He concluded by saying that these and other behavioral biases may ultimately affect the efficacy of TILA, so regulators and researchers need to carefully measure the effectiveness of disclosures with both small- and large-scale experiments.

Reflecting on the recent financial crisis, Paul Willen of the Federal Reserve Bank of Boston pondered why so many people made such (seemingly) poor decisions — borrowers took out mortgages they could not afford, and investors lent to borrowers who could not repay. One argument has been that borrowers did not understand the terms of their mortgages, particularly the resets of adjustable rate mortgages they did not anticipate.

While many consumers might not have understood their mortgage terms, Willen argued that it is not sufficient to explain most of the defaults that did occur. Research conducted by Willen and his colleagues at the Boston Fed found that 88 percent of borrowers who defaulted on their mortgages between 2007 and 2010 were making the same payment when they defaulted as the day they obtained their mortgage. Fifty-nine percent of those borrowers had fixed rate mortgages, and most of the borrowers with adjustable rate mortgages defaulted on their loans before the interest rate reset, or their interest rate did not increase when it was reset.

Willen suggested an alternative explanation: Prior to the crisis, borrower and investor decisions were driven primarily by optimism about house prices. Surveys conducted during the housing boom reveal that many consumers in a number of U.S. cities expected house prices to increase an average of 12 percent a year over the next decade (Case, Schiller, and Thompson, 2012). Willen argued that consumers responded rationally to these irrational expectations. Borrowers expected to pay 6 percent per year for their mortgage and to realize home price appreciation more than double that cost, so it made sense for them to obtain as much leverage as possible. Willen concluded that even if there were perfect disclosures of contract terms, borrowers may make poor decisions if they have unreasonable expectations about home prices, the expenses of maintaining a home, and so on.

Willen used the example of the new disclosure forms proposed by the CFPB a few months before the conference. According to Willen, a significant amount of space (particularly on the first page) is devoted to information about changing payments, and yet, during the last crisis, interest rate resets were not the primary driver of defaults. For this period, at least, he suggested that disclosure forms should have provided historical information on foreclosure/default probabilities for similar borrowers and for a range of hypothetical declines in home prices. He conceded that disclosing probabilities of negative events may not prove successful in preventing individuals from taking on excessive risks. The question of which form of disclosure is most effective in creating good outcomes remains an empirical one.

Ultimately, each borrower may only need limited information when making a decision to purchase a home and/or take out a mortgage, but this information may vary from individual to individual or from period to period. Such variability poses a significant challenge to the design of effective mandatory disclosures. Members in the audience argued that tailored disclosures (based on borrower characteristics and economic circumstances) are unlikely to be practical for lenders from a compliance perspective. Trying to cover all the possibilities would inevitably result in disclosures that would be neither simple nor concise. Such disclosures are unlikely to be effective so the focus of disclosures may necessarily revert back to simple cost information.

IV. Unfair, Deceptive, or Abusive Acts and Practices

One of the main regulations governing the product selection phase of a consumer's search for credit prohibits any unfair, deceptive, or abusive acts and practices, but considerable challenges exist in establishing empirical criteria for when an act or practice qualifies under one of these labels. The third panel's moderator, Marsha Courchane of Charles River Associates, illustrated each of the three concepts by considering hypothetical cases in which the panel composition or content was changed at the last minute. Dedicating the entire allotted time to one panelist instead of all three would certainly be unfair to the other two panelists, yet at the same time, it would allow an extremely

knowledgeable panelist to have the floor for longer, so measuring the costs and benefits to the panelists and to the audience would prove challenging. A deceptive act might consist of notifying the audience that the panel will, in fact, not discuss UDAAP but instead the World Series, despite the audience's expectations. And an abusive act might involve Courchane completely changing what it means to be a moderator and speaking during the entire time allotment, thus taking advantage of the audience's expectation of her role. Measuring harm to the audience in each of the latter two cases is challenging, if not impossible, and each act takes advantage of the audience's understanding of what a reasonable panel might deliver. Courchane added that measuring harm from products and services offered by financial institutions might be considerably easier than for other products because of the extensive data collection efforts on the part of the lenders. At the same time, she argued, the guidance provided by the CFPB so far does not contain enough specificity for financial institutions to conduct a comprehensive ex-ante analysis that could altogether prevent acts and practices that would be found, ex post, to be UDAAP.

Howard Beales of George Washington University provided a brief history of unfair and deceptive acts and practices (UDAP), originally added to the Federal Trade Commission Act (FTC Act) in 1938. Early on, the FTC applied the deceptive provision more often than the unfairness provision, based on what was termed "a fool's test," one that focused on the clarity of advertising.¹⁰ Over time, the FTC's approach shifted toward considering the meaning of a message for an ordinary or average member of the audience, summarizing its criteria in its Deception Policy Statement from 1983. This document considered a practice deceptive if it was likely to mislead consumers who were acting reasonably in the circumstances about a material issue. Beales noted that the FTC first used the unfairness principle in 1964 to issue the first warning requirements for cigarette packages. In its Cigarette Rule, the FTC defined a practice as unfair if it is immoral, unscrupulous, or unethical; if it caused substantial consumer injury; and if it violated public policy. Beales

¹⁰ Beales provided a curious example of the Columbia Desktop Encyclopedia, which promised to contain everything one ever wanted to know about every conceivable subject, a claim the FTC refuted.

describes how, eventually, the FTC's unfairness jurisdiction came under serious attack following a period of aggressive application of this doctrine by the FTC. After reviewing many cases, in 1980, the FTC adopted the Unfairness Policy Statement, which focused on substantial consumer injury as the key element of unfairness — the substance of this definition of unfairness persists today.

Beales argued that the FTC's primary focus on unfairness has always been consumer sovereignty — in other words, the role of the regulator is “not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking.” Secondly, any such seller behavior must cause substantial injury to the consumer in order to be deemed unfair. In thinking about measuring injury to the consumer, “substantial” may mean a large harm to few consumers or a small harm to a large number of consumers, but any such injury must be substantial compared with any offsetting benefits a consumer receives. Any remedy required to rectify the unfairness may involve offsetting benefits, such as the cost of disclosures or security measures that may be required to protect consumers. Consumers may also receive offsetting convenience benefits or benefits from credit availability. The consideration of injury and offsetting benefits to consumers lends itself naturally to an empirical cost-benefit analysis, but data availability nevertheless often complicates the measurement of both elements.

The third element of unfairness, Beales noted, is reasonable avoidance — in other words, resisting the urge to substitute the regulator's judgment for the consumer's own decision. If a product or practice can reasonably be avoided (in Beales' example, by selecting healthy foods instead of going to McDonald's), the product or practice is not unfair simply because it causes substantial injury to the consumer (in the case of McDonald's, to the consumer's health). Generally, unfairness has been used to remove barriers and to pro-

tect the consumer's ability to choose but not to restrict substantive terms of contracts themselves.

Given this principle, Beales argued, the Board misapplied the unfairness principle in setting the default pricing rule in its 2008 rulemaking on penalty pricing for credit cards. The Board did so by focusing too much on the price paid by consumers and by failing to pay appropriate attention to offsetting benefits of the default pricing provision in terms of potential risk management benefits and credit availability effects, or to the reasonable avoidance principle.

Beales concluded by calling attention to complications presented by applying UDAAP principles in an environment with examiner discretion — an issue with which the FTC did not have to contend in the past — and the challenges that this may bring for both lenders and regulators. In the absence of a well-developed set

“[The unfairness standard is] not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking.” — FTC, Policy Statement on Unfairness

of guidelines and analytical principles guiding examiners in assessing potential UDAAP violations and clear expectations for lenders in developing their products and services, examiner discretion may introduce compliance uncertainty.

Deborah Morris of the CFPB addressed the legislative history of UDAAP, in particular the “abusive” provision that was added as part of Section 1031(d) of the Dodd-Frank Act of 2010. She remarked that commentators have noted that there appeared to be a gap between what unfairness and deception cover, and abusiveness was intended to fill in that gap.

Morris reiterated the definition of “abusive” in Dodd-Frank: an act or practice that either materially interferes with the ability of the consumer to understand a term or condition or takes unreasonable advantage of one of three situations: 1) a lack of un-

derstanding on the part of the consumer of the material risk, cost, or conditions of the product or service, 2) the ability of a consumer to protect the interests of the consumer in selecting or using a consumer financial product or service, or 3) the reasonable reliance by the consumer on the financial institution to act in the interest of the consumer.

Next, Morris reviewed some relevant components of the CFPB's published examination guidelines that pertain to UDAAP. For example, examiners may conduct a risk assessment, which means reviewing the nature and structure of a product and the consumers at whom the product is targeted. They may review the volume and nature of consumer complaints. They may study the volume of refunds/chargebacks associated with the product. And they may review marketing methods for a particular product, procedures for ongoing customer relationship management, and the compliance management process of the organization. After conducting a high-level assessment, Morris stated, examiners may identify areas for potential transactional testing, including testing of disclosure documents. She pointed out that any conclusions about actual violations are made in collaboration with CFPB headquarters in Washington, D.C., and are not left solely to the discretion of each examiner.

Jo Ann Barefoot of Treliant Risk Advisors (now at Jo Ann Barefoot Group, LLC) discussed some of the uniqueness of UDAAP challenges, particularly from the perspective of financial institutions. She argued that UDAAP exists in a "political vortex" in which more politicians and commentators than ever before are interested in potentially abusive practices. She noted that while many of the principles of the unfair and deceptive standards are mature, the current environment is changing rapidly. Barefoot argued that the scope of UDAAP is fairly broad when compared with the scope of the early FTC cases. She noted that in her experience and based on the many settlements related to alleged UDAAP violations, UDAAP questions strongly permeate CFPB examinations, appearing to take precedence over traditionally high-priority issues such as fair lending.

As a result, financial institutions are facing a challenging environment in which the traditional checkbox-centric compliance machinery cannot effectively address UDAAP issues. Barefoot argued that the

consumer-centric approach taken by the CFPB identifies what customers perceive as unfair and then traces back to the institution's acts or practices that caused the perceived unfairness. More often than not, she observed, issues arise in functional areas "in the cracks" that traditional compliance exams or in-house reviews have not touched. These are issues that compliance officers may not anticipate or immediately understand.

Barefoot shared that, based on her conversations with representatives from the CFPB, a thought process on the part of the financial institution that is mindful of the risk to the consumer is actually the goal. In such an environment, regulators are challenging practices that comply with technical rules but may not satisfy the overlay of subjective standards on UDAAP. She indicated that regulators appear to hope such subjective risk will deter financial institutions from acts or practices that may cause harm to the consumer even if they are not technically illegal, in the sense that they may not be governed by regulations other than UDAAP.

Subsequent interaction with the audience suggested that many financial service providers do not feel there is sufficient specificity in the guidance to assist them in identifying specific conditions (whether measurable or not) that would render an act or practice declared UDAAP. Overall, there was a clear tension between the desire for specificity and flexibility in the determination of UDAAP. Beales, Barefoot, and audience members argued for more explicit criteria that can be methodologically applied by lenders. But even this would not be a simple exercise. Using empirical method and measurement to balance costs to consumers against the "countervailing benefits" can be challenging in itself, and thinking about costs to institutions and society is equally so. The discussion during this part of the conference suggested that lenders likely will have to assume a level of uncertainty about regulation and enforcement until more experience is gained. If that proves to be the case, it will be important to think carefully about ways to measure the costs and potential benefits of that uncertainty.

V. Changes to Revolving Accounts

The next panel focused on the management of existing relationships with borrowers, using the recent example of the CARD Act. David Silberman of the

CFPB opened the conversation with remarks about the background and rationale for the CARD Act. He began by making three observations about the credit card market. First, every credit card issuer has a strong appetite for adding new accounts. Second, the market for credit cards is and has for some time been extraordinarily saturated, such that most new customers can only be added by inducing switching from other lenders. And third, card issuers have been remarkably successful in capturing new accounts (on the order of 80 million new accounts per year, or roughly one new account for every two consumers with a credit score above 500 or 550).

The business model prior to the CARD Act that made these basic market characteristics possible, Silberman argued, featured obscured pricing of the true cost of credit, rich switching incentives, an initial APR below the ex-ante prediction of risk for the account or the account cohort, and a revenue model reliant on back-end repricing and penalty fees. Unlike most installment loan contracts, a typical credit card contract gives the lender significant flexibility to alter terms (including interest rates and fees) at any time. This ability to reprice an account later in the relationship may, in part, explain the ability of lenders to offer more competitive introductory rates and other incentives to entice consumers to switch accounts.

Silberman described a number of the prices cardholders may experience over the course of a credit card relationship. These might include, for example, fees and/or interest rate increases for late payments and purchases over the credit limit. For a time, some credit card contracts included a “universal default” clause, which permitted lenders to raise interest rates on an account in good standing because the consumer experienced a delinquency on another loan, or because his or her credit score fell significantly. Silberman also described the complexity of certain billing practices such as double-cycle billing or payment allocation rules that apply payments to the lowest interest rate balance on the account (as opposed to paying down the balance with the highest interest rate first).

According to Silberman, prior to the CARD Act, approximately 28 percent of accounts were triggering a delinquent fee in a given quarter, and the average fee was in the range of \$35. This pricing system raises at least two questions, according to Silberman. The first

is whether most consumers really understood the terms of their accounts (or only some terms because others were “shrouded”). The second is whether a profit model based on a small cohort of consumers who trigger penalty fees was “fair” (both in the technical and conversational sense of the word).

Against this backdrop, in 2008, the Federal Reserve and a number of other agencies, under their authority to prevent unfair or deceptive practices, published rules regulating these and other practices.¹¹ Congress codified these rules and expanded them in May 2009 in the form of the CARD Act. Some of the new restrictions contained in the act came into force very quickly, while others were implemented in February 2010.

Silberman argued that the act was intended to affect certain components of credit card pricing, though in a way that changes the *manner* of pricing card credit instead of the actual *cost* of credit. Warning of the dangers of drawing causal conclusions from trends, he pointed to a sharp drop in late-fee and overlimit-fee incidents once the CARD Act took effect, as well as a significant decline in the repricing activity of existing balances. Silberman argued that these and other changes to card contracts may or may not have caused the overall cost of credit to change, but positive outcomes of the act included more transparent and upfront pricing. He also warned that an exclusive focus on interest rates is likely misguided and that more robust measures of the all-in cost of credit must be considered instead when discussing the consequences of the CARD Act because, in his view, the CARD Act in fact *was* intended to change the banks’ source of credit card revenue.

Oliver Ireland of Morrison & Foerster discussed the Federal Reserve UDAP rule of 2008. The proposed rule contained provisions limiting interest rate increases, mandating advance notice of rate increases, limiting double-cycle billing, mandating reasonable and proportional penalty fees, imposing changes to the timing of mailing monthly statements, imposing an ability-to-repay test, and other requirements. Ireland also discussed the credit card industry’s effort, undertaken as the rule was debated, to estimate some of the

¹¹ For further detail, see also <http://www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm> (accessed May 22, 2014).

effects of the alternatives the agencies were considering. A number of credit card issuers (representing around 70 percent of the card market) signed a joint representation agreement with Morrison & Foerster and contracted Argus Information & Advisory Services to combine their portfolio data and attempt to project the potential costs and consequences of the proposed rules.

The comment letter submitted by Morrison & Foerster to the Board considered the potential impact of several aspects of the then-proposed rules: 1) prohibition of increasing interest rates on outstanding balances, 2) the 45-day notice provision for any increases in interest rates, 3) payment allocation to highest interest balances first (including the promotional/grace period provision), and 4) all pricing limitations in this list, collectively. The analysis provided calculations of interest lost on accounts that would be subject to interest rate increases due to their past-due status but could not be repriced under the UDAP rule, as well as interest lost due to the notice period, grace period, and payment allocation provisions. The data used for this purpose were account-level information provided by each of the issuers that joined the study, including information on balances, interest rates, past-due status, fees paid, and so on.

The core analysis estimated that revenue losses to the industry due to the collective limitations previously described under the proposed UDAP rule would amount to approximately \$12 billion annually.¹² The comment letter considered two thought experiments for how the industry might offset the lost revenues or retain the same profit margin. First, the industry could reduce credit lines by about \$931 billion (which could approximately be accomplished by excluding all consumers with a credit score below 620 from the credit card market). Second, the average interest rates on all credit card accounts could be increased by about 1.6 percentage points. At the request of the Federal Reserve, Argus also provided other estimates for different scenarios.

¹² It should be noted that the final rules implemented under the CARD Act were not exactly the same as those proposed by the Board and that market conditions have changed since this calculation was made. If the exercise was repeated, based on subsequent conditions, the resulting estimate might be higher or lower.

A similar exercise was undertaken in the area of penalty fees, particularly for late payment fees. Ireland shared that the cost analysis for a late payment produced results of approximately \$28.40 per late payment for the lender. The industry argued that, in addition to recovering costs, penalty fees were intended to deter late payments. A rule requiring that late fees should be proportional to cost might preclude fees that are sufficiently large to achieve such a deterrence effect. After an elaborate process of measuring and modeling cardholder responsiveness to late fees, the industry submitted comments to the Federal Reserve suggesting there was an inflection point around \$50, after which the deterrent effect grew particularly strong. Ultimately, the UDAP rule capped the initial penalty fee at \$25 and a second incident within six months at \$35, which Ireland posited was designed to deal with the deterrence problem.

Michael Heller of Argus Information & Advisory Services then presented an up-to-date analysis of the account-level data Argus has continued to collect since the initial effort in 2008. He presented statistics on the number of new accounts created before and after the CARD Act. These charts show a significant reduction in new accounts during the recent crisis, followed by some recovery in new account volume in 2011 and 2012. Heller pointed out that much of this recovery has occurred among the most creditworthy customers. New account volume for consumers with subprime and near-prime credit scores remains significantly smaller than before the crisis.

Heller pointed out that approximately 25 percent of outstanding credit lines were taken out of the market in 2009/2010 (either by line decreases, account closures, or charge-offs). As a result, the average consumer overall has fewer credit card accounts. Credit lines on new accounts are also lower, on average, than before the crisis. He noted that, among consumers with very high credit scores (approximately 760 or above), the size of average credit lines has been recovering. Finally, Heller showed that automatic credit line increases have virtually disappeared, largely due to the income verification requirements in the CARD Act.¹³

¹³ These are periodic increases in credit lines initiated by the lender without receiving a request from the cardholder.

The models that banks previously used for income estimation have been thrown away, and underwriting models have been altered as a result.

Next, Heller presented a variety of measures of interest rates and interest income, comparing values in 2007 with today. Heller showed that the average yield for new accounts (those less than 12 months old) has decreased. This is surprising given that a higher proportion of new accounts are being opened by more creditworthy consumers. At the same time, the difference between the interest rate on new accounts and the prime rate — an important measure of the price of credit — has increased.

Heller then presented statistics on interest rates charged on credit card accounts that were two or more years old (the bulk of the accounts in his data). He showed that the relationship between prime rate adjusted APR (APR – prime rate) and contemporaneous credit scores has changed since the passage of the CARD Act.¹⁴ Using this measure, all consumers are paying more relative to the rate they received in 2007, but the increase in rate is smaller for less creditworthy consumers and larger for more creditworthy consumers. Heller suggested that this is the result of limitations on risk-based repricing imposed by the CARD Act.

Considering different modes of account repricing, Heller showed that penalty repricing (triggered by a very small share of accounts both before and after the CARD Act) of existing balances has remained at a steady level, as has promotional expiration repricing.¹⁵ Behavior-based repricing, which was on the rise leading up to the CARD Act, has virtually disappeared and is now only applied to new balances.¹⁶ Late fee assessments have

¹⁴ In other words, prime rate adjusted APR is a measure of the interest rate “spread” between the interest rate charged to the consumer and a benchmark cost of funds to the lender (in this case, the prime rate).

¹⁵ Refer to Appendix A for definitions of the various forms of repricing described here.

¹⁶ Heller clarified during the Q&A that the number of accounts that are repriced for behavioral reasons after the CARD Act may appear to be approximately the same as the number of accounts that were repriced before the crisis but that the dollar value of balances repriced has dropped dramatically because the CARD Act mandates repricing only on new balances and not on existing balances.

declined on active accounts, with the average assessed late fee down to approximately \$28, and overlimit fees have virtually disappeared as well. Heller presented slides on consumer revolving activity, showing that consumer deleveraging and the reduction in subprime credit availability have decreased the share of accounts that revolve a balance to approximately 60 percent.

Geng Li of the Board presented his research (performed jointly with Song Han and Benjamin J. Keys) that speaks to the ways in which the CARD Act has potentially changed the supply of credit card loans.¹⁷ Li and coauthors used Mintel Comperemedia’s database of credit card mail offers in order to proxy for credit supply and attempt to disentangle changes in the supply of credit due to the CARD Act from demand-side factors, long-run trends, and the effect of the financial crisis on the credit card market. In particular, they focused on how the supply for credit has changed for consumers with bankruptcy flags in their credit reports relative to consumers without such flags.

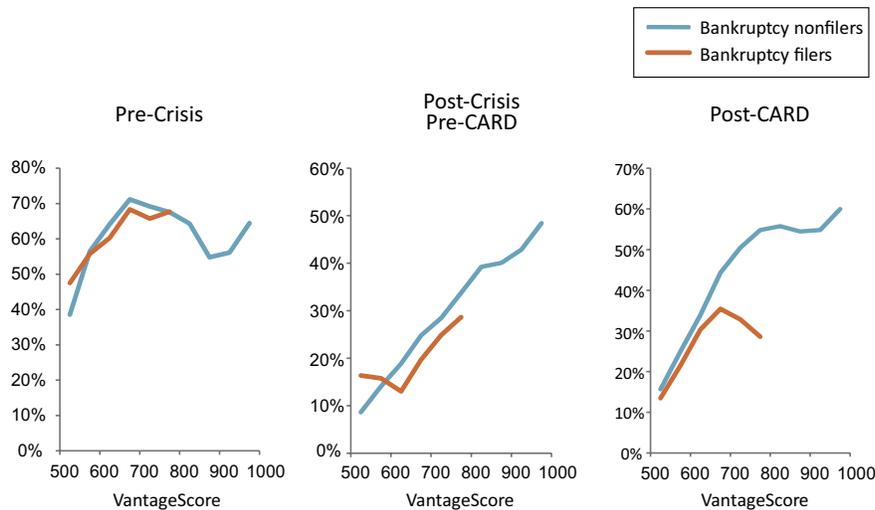
Li presented a number of charts showing the relationship between the consumer’s current credit score (in this case VantageScore) and the probability of receiving a credit card offer.¹⁸ The charts plot these probabilities for three distinct periods: 1) before the financial crisis (year 2007), 2) after the financial crisis, but before the implementation of the CARD Act (between August 2009 and February 2010), and after the CARD Act (after February 2010). See Figure 1. Relative to the precrisis period, the number of new credit card offers fell dramatically during the aftermath of the crisis but before the CARD Act. The decrease was most pronounced for consumers with lower credit scores. Li pointed out that there was some recovery in the number of new credit card offers in later years and after the CARD Act regulations came into force. But most of this improvement occurred among consumers with higher credit scores. Li stressed that while these changes are suggestive of some effects of the CARD Act, they are hardly conclusive.

Next, Li presented his analysis of credit supply for consumers with and without a bankruptcy filing.

¹⁷ Han, Keys, and Li (2011).

¹⁸ VantageScore is an alternative measure of creditworthiness to the FICO score.

Figure 1
Likelihood of Receiving a Credit Card Offer



Source: Han, Song, Benjamin J. Keys, and Geng Li (2011). “Credit Supply to Personal Bankruptcy Filers: Evidence from Credit Card Mailings,” Finance and Economics Discussion Series 2011-29. Board of Governors of the Federal Reserve System (U.S.).

Note: VantageScore is a form of a credit score.

among consumers with lower credit scores.

Finally, Li showed that the incidence of annual fees was similar for bankruptcy filers and nonfilers before the CARD Act, but bankruptcy filers are much more likely to be offered a credit card with an annual fee after the CARD Act. Li concluded that there is some evidence that the CARD Act has changed the supply of credit, at least for the group of consumers with a history of bankruptcy, though it is not clear from the data thus far whether this change is a transition or a permanent shift in practices for financial institutions.

The panel agreed that some of the expected trends following the CARD Act, such as increasing upfront APR, reductions in penalty fees and unsolicited line increases, and fewer lines for consumers without a demonstrated ability to repay, appear to emerge from the data. However, it is difficult to measure what portion of these changes can truly be attributed to the act. Li’s study using credit card solicitations as a proxy for credit supply is a first step in the direction of disentangling the effects of the crisis and other regulations from the effects of the CARD Act. But better data and an even stronger methodology for isolating the effects of the CARD Act alone are required for the derivation of reliable estimates. A clear divergence of opinions emerged around whether features of the CARD Act such as higher upfront prices are “desirable” compared with penalty-based price increases — the challenge for future work will be to actually measure the welfare implication of either approach in making such an assessment.

Prior to the crisis, two consumers with similar credit scores — one with and the other without a bankruptcy flag — had nearly the same likelihood of receiving a credit card offer. After the crisis, but before the CARD Act, the presence of a bankruptcy flag for one of two consumers with similar credit scores was associated with a lower likelihood of receiving a credit card offer. After the CARD Act came into force, the differential between bankruptcy filers and nonfilers increased substantially among consumers with a relatively high credit score. See Table 1.

Li then presented a set of charts comparing the interest rates offered with bankruptcy filers and nonfilers with similar credit scores. Prior to implementation of the CARD Act, there was little difference in the interest rate spread (relative to two-year Treasury yields) offered to filers and nonfilers. After the CARD Act was implemented, bankruptcy filers were offered contracts with higher interest rates than nonfilers with similar scores, and this gap was especially pronounced

VI. Consumer Financial Protections and Consumer Complaints

The Dodd-Frank Act contains a provision mandating that the CFPB accept complaints directly from consumers about the challenges consumers face in the market for credit. The law includes a major departure from previous efforts in complaint collection in financial services, such as the FTC Sentinel system. The CFPB's Consumer Response team is required to bring the received complaints to the attention of financial institutions and monitor their resolution, as well as analyze and publish the collected data. The panel focusing on consumer complaints discussed the potential benefits and challenges that arise from the analysis and use of such complaint data in the market for consumer credit.

Bob Hayes of TCELab, an expert in measures of consumer satisfaction and dissatisfaction, discussed the ways in which different companies already use

complaint data, how such data can be useful, and some ways in which we can measure the validity and reliability of the data. He pointed out that the CFPB is part of a larger customer feedback system that has been used by companies to understand their business data, make their customers happier and more loyal, get their customers to buy more or different products, or tell their friends about the products. Typically, companies use a variety of feedback, including social media, structured surveys, and brand communities. In the case of financial institutions, the CFPB complaint system is an additional source of information. The collected information can be quantitative or qualitative in nature, and Hayes's research shows that companies that effectively use consumer feedback data tend to be more successful and have more loyal customers.

Hayes argued that there are two components of the quality of self-reported data (i.e., complaints, ratings): reliability and validity. Reliability refers to the consistency and stability of complaints/ratings

over time or over categories of questions, whereas validity is about the meaning of the ratings. In analyzing CFPB complaint data published for the period of June 1 through August 29, 2012, Hayes argued that the data exhibit a degree of stability in the relative ranking of issues about which consumers complain and that the share of complaints each issue received is also relatively stable over time. See Figure 2.

With respect to validity, Hayes compared the CFPB complaint data with data collected

Table 1
Regression Analysis of Additional Costs and Other Fees

Sample Period	Dependent Variables		
	1 Waived annual fee Probit	2 Minimum finance charges OLS	3 Have other fees Probit
Pre-Crisis	-0.048***	0.174 ***	N.A.
Post-Crisis, Pre-CARD Act	N.A.	0.233***	0.230***
Post-CARD Act	-0.002	-0.028**	0.118***
	(0.007)	(0.011)	(0.017)

Source: Han, Song, Benjamin J. Keys, and Geng Li (2011). "Credit Supply to Personal Bankruptcy Filers: Evidence from Credit Card Mailings," Finance and Economics Discussion Series 2011-29. Board of Governors of the Federal Reserve System (U.S.).

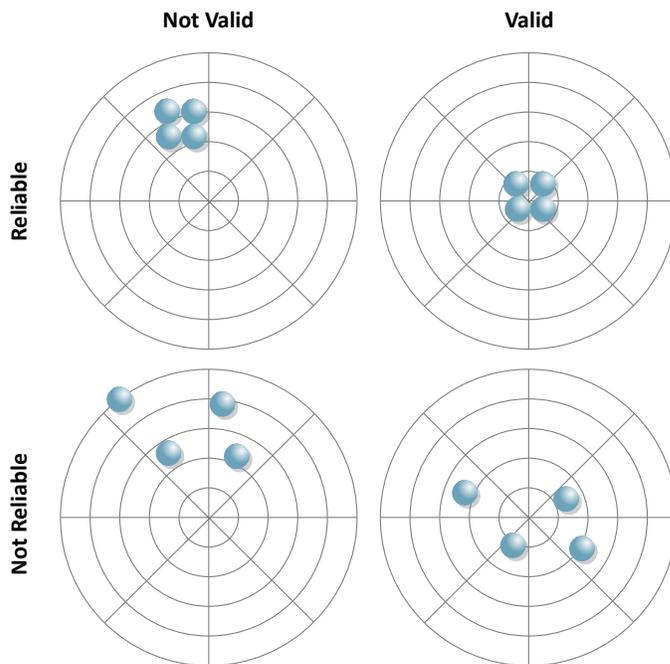
Note: The table shows the estimated relative likelihood that bankruptcy filers will receive a credit card offer with certain additional costs and other fees. Reported in the table are the estimated coefficient (for the OLS specification) or marginal effect (for Probit specifications).

*** indicates significance at the 99% confidence level

** indicates significance at the 95% confidence level

Figure 2 Two Measurement Criteria for Customer Metrics

1. **Reliability** is about precision/consistency of the metric.
2. **Validity** is about meaning of the metric.



Source: The Federal Reserve Bank of Philadelphia is reprinting this graphic with permission from Business Over Broadway.

by J.D. Power and Associates on consumer satisfaction with financial service providers in order to assess whether institutions with more complaints tend to have lower consumer satisfaction in the J.D. Power survey. After he normalized CFPB complaint totals for the number of credit card customers by institution (to account for the fact that larger institutions tend to have more complaints mechanically), Hayes created a rank-ordering of the top 10 financial institutions and correlated this rank to the J.D. Power rank ordering based on satisfaction. For this limited sample, the correlation is -0.68 , indicating that the CFPB complaint data relatively closely reflects overall consumer satisfaction with financial institutions. Hayes emphasized that this analysis is relatively crude and could be improved by considering different elements of satisfaction compared with similar elements in the complaint data and by

expanding the number of institutions included in the analysis.

Scott Pluta of the CFPB's Office of Consumer Response (Consumer Response) gave a thorough overview of the CFPB's complaints system, provided some clarification about the timing of complaints resolution, and discussed potential future uses of the data. The CFPB accepts complaints via several different channels (telephone, mail, web, fax, and referral). Consumer Response screens all complaints submitted by consumers based on several criteria. These criteria include whether the complaint falls within the CFPB's primary enforcement authority, whether the complaint is complete, and whether it is a duplicate of a prior submission by the same consumer. Screened complaints are forwarded to the appropriate company via a secure web portal. Companies review the information, communicate with the consumer as needed, and determine what action to take in response. Companies report back to the consumer and the CFPB via a secure web portal. Companies have 15 days to provide a substantive

response to the consumer and the CFPB and are expected to close all but the most complicated complaints within 60 days. The CFPB then invites consumers to review the response and provide feedback. Consumer Response reviews the feedback that consumers provide about company responses, using this information along with other information, such as the timeliness of the company's response, to help prioritize complaints for investigation. In some cases, Consumer Response has referred complaints to colleagues in the CFPB's Division of Supervision, Enforcement, and Fair Lending & Equal Opportunity for further investigation.

Consumer Response shares complaint data with internal stakeholders, federal and state governments, and the FTC's Sentinel system. And since June 2012, the CFPB also makes anonymized complaint data available to the public via the Consumer Complaint Database

on the CFPB's website.¹⁹ Pluta shared the CFPB's plans to release additional data fields and possibly consumers' complaint narratives.²⁰ He also emphasized that the CFPB goes to great lengths to verify a relationship between the consumer and the company in the complaint, as well as to establish jurisdiction, but it does not opine on the merits of complaints.

Beth Satter of Citigroup discussed some challenges with the complaint resolution process and interpreting the information gleaned from complaints. For example, Satter suggested that variations in complaint resolution metrics may say more about complaint resolution processes within a bank than they do about the complaint itself. Similarly, differences in the CFPB's complaints information may be affected by differences in the proportions of banks' customers who approach the bank directly rather than going to the CFPB.²¹

Given the sheer volume of transactions that a large bank processes, Satter acknowledged that mistakes will be made. She argued that complaints can be thought of as stemming from three different categories of issues: individual customer issues, processing/execution errors, and business practice issues. Errors often occur on an individual customer basis and are relatively easy to resolve, even if their volume may be relatively high. Processing errors tend to have a more systemic source but often affect many consumers at once. Complaints are crucial in identifying and investigating the underlying processing error. But once identified, those processing errors can be prevented in the future. Business practice

¹⁹ When the conference was held, the Consumer Complaint Database only contained data about credit card complaints and 11 data fields. Since then, the CFPB has added data on complaints submitted about a number of additional consumer products and services, including mortgages, consumer loans, private student loans, and bank accounts/services. The CFPB has also increased the number of fields contained in the database.

²⁰ The CFPB recently proposed to give consumers an opportunity to opt in to share their complaint narratives in CFPB's public complaint database. For more information, see <http://www.consumerfinance.gov/newsroom/cfpb-proposal-would-give-consumers-the-opportunity-to-publicly-voice-complaints-about-financial-companies/>.

²¹ Bank A may have higher volumes through the CFPB Complaint Portal than Bank B. Bank B may have the same types and volumes of complaints, but its customers may contact the bank directly more often than the customers at Bank A. These differences would not be visible through the complaint portal alone.

issues typically also affect multiple customers, may take considerable time to resolve, and often have multiple solutions (by business line or product, for example).

Satter concluded by pointing out that complaints are an important ex-post indicator of problems. But the true goal is to avoid the problems that generate complaints in the first place. Since a zero-complaint environment is simply unrealistic, she argued for a focus on resolution speed and efficacy in the case of individual consumer complaints, strengthened controls within institutional processes in the case of processing errors, and research and process reviews in the case of business practice issues. Priority placed on customer satisfaction, Satter argued, should lead the CFPB and financial institutions to group and analyze complaints in such a way that all organizations can spend their time and resources on solutions that will have the largest effect on the consumer experience with financial services.

A number of additional observations were made during the discussion. For example, controlling for the number of customers, product mix, and type of customers a financial institution has may be relevant in interpreting the publicly available complaint metrics and comparing financial institutions. Customers who revolve credit card balances tend to have lower satisfaction than those who do not carry a balance, for example, so complaints may reflect the underlying business model of the institution. Pluta argued that the decision of how to normalize data may ultimately rest with the consumer or analyst. But he also suggested that there may be a role for the CFPB to make available data that can be used for that purpose (for example, number of active accounts, number of closed accounts, and so forth).

Pluta suggested there may be early evidence that the Consumer Complaint Database has encouraged some lower ranked institutions (in terms of complaint resolution) to improve the speed and quality of their complaint resolution processes. This would improve competition, Pluta argued. Audience members cautioned that the public database may also be inducing financial institutions to resolve complaints before a consumer even approaches the CFPB, thus obscuring potential procedural or regulatory issues that may underlie the complaints. The possibility of the public database as an incentive for obscuring potential regulatory violations was left for future discussion.

VII. Recurring Themes and Conclusions

Several prominent themes emerged during the conference, particularly in the concluding panel, in which moderators from previous panels reconvened for a discussion of key takeaways from their panels and the key insights on the use of measurement to refine consumer protection regulations.

A. Disclosures, Information Delivery, and Consumer Comprehension

One of the most striking patterns during the conference was the return to the issues of information disclosure and presentation and the ways in which the consumer interprets and comprehends the presented information. Despite TILA's advanced age, relative to many other regulations, the discussion on the effectiveness of disclosure requirements appears far from over. In fact, insights from research on disclosures may become a key ingredient in the analysis of potential UDAAP violations and in the design of consumer complaint collection and dissemination mechanisms.

Matthew Neels of Capital One posited that effective disclosure of terms and conditions has become simply “the price of admission” to the marketplace and now represents a minimum standard of communication between financial institutions and consumers. Neels shared that industrywide surveys on CreditCard.com and CardHub.com show a marked improvement in the clarity and reading indices of credit card disclosures, yet the majority of consumers older than 16 are rated less than proficient at reading complex texts. As the conference panelists emphasized time and again, the science of information processing is relevant not only during the shopping and selection phases of a credit product but also during subsequent interactions between the institution and consumer.

Information exchange is important in thinking about potential UDAAP violations as well. One aspect of a UDAAP cost-benefit analysis depends on expectations of consumer comprehension and whether the presented information may or may not be reasonable for a consumer to understand. Disclosures reemerge for revolving accounts when the terms of the contract change, are proposed to change, or perhaps when disclosures are repeated because consumers are prone to forgetting, as Driscoll mentioned. Finally, the lessons

from disclosures are also relevant to understanding the effects of publishing complaints information. Panelists for the consumer complaints panel returned to the same kinds of questions covered earlier in the conference regarding the ways in which consumers process the information presented to them and how the manner of presentation may affect their decisions.

It was clear from the discussion that the role disclosure requirements play — or should play — requires ongoing study. Conference panelists tended to agree that future research should attempt to measure an average/representative consumer's ability to comprehend financial information instead of relying on a potentially imprecise definition of a “reasonable” consumer. Participants felt the industry and the regulatory agencies should endeavor to measure the way consumers process information and how information influences (or does not influence) their decisions. Such an analysis would bear consequence for future refinement of disclosure requirements and help financial institutions communicate more effectively with consumers at every stage of the credit life cycle.

B. The Role of Related Markets

Credit products are inherently forward-looking. Expectations of future interest rates, collateral values, income, and other factors influence the value of engaging in, or continuing to participate in, any credit transaction. As Willen pointed out in his presentation, a major contributor to rising default rates for mortgages during the recent crisis was falling house prices, which was not anticipated by the vast majority of consumers as well as many financial services providers and regulators. Several panelists and audience members expressed conflicting feelings about the extent to which financial services providers or regulators should be providing information to consumers on independent measures of expectations about related markets and other factors relevant to making a decision about a loan product.

During the closing panel, Courchane pointed out that the tradeoff between downside risk and access to credit is a very real one and requires considerable attention. If the public policy goal is to minimize downside risk, traditional operational and underwriting controls alone may be able to accomplish that goal effectively. Courchane noted that having “skin in the

game,” either on the demand side or the supply side, certainly reduces downside risk. At the same time, erecting barriers in terms of loan-to-value or debt-to-income ratios also reduces access to credit, sometimes to the most vulnerable populations.

C. Measurement, Scientific Method, and Consumer Protection Regulations

During the concluding panel, Neels emphasized that the relationship between disclosures and consumer shopping behavior is not well understood in the modern setting of online comparison tools. He questioned whether the overarching insight that consumers tend to comparison shop surprisingly infrequently (particularly young and elderly consumers) is related to how questions are asked. Neels commented that further research is needed to understand whether consumers are intimidated by comparison shopping or they are simply comparison shopping in a way that has not yet been isolated by researchers (for example, by using websites such as BankRate.com or CreditCards.com before applying for credit). Insights from such studies would have a considerable effect on how TILA requirements are implemented in terms of serving as a tool for comparison shopping for consumers.

Participants generally agreed that researchers are better at measuring the potential costs of regulation to consumers than the benefits they may produce. For example, Courchane noted that regulators have created an effective apparatus to collect information about the costs to consumers but that UDAAP guidelines have an explicit consideration of countervailing benefits to the consumer that are not always easily identified. Furthermore, Courchane argued, the burden of the benefit arguments seems to be institution-specific so that each institution appears to have to rely on clearly measuring and articulating the benefits of each product for its own business model and customer base instead of pointing to prevalent practices in the market. This approach can be challenging when considering new products, and it is definitely not part of a systematic framework across different institutions in the United States at this time.

Courchane also argued that it will be challenging to reach a balance from a regulatory, institutional, and consumer awareness perspective that isn't more complicated than the system in place before the crisis.

She pointed out that the previous approach of mailing a new offer to a group of consumers identified by a credit repository is not adequate in an environment where institutions have to consider what a consumer would think about a product or feature at each stage of the relationship. In other words, the potential for the consumer to perceive a product or service as unfair, deceptive, or abusive represents a new challenge for financial institutions. Courchane suggested two approaches to measuring consumer comprehension and sentiment: focus groups and analyses of earlier complaints for similar products. In either case, she argued that some degree of scientific method is necessary in order to measure benefits to consumers effectively.

A crucial aspect of the measurement problem is establishing that the relationships being estimated are truly cause-and-effect. Hunt addressed this point using the example of studies of the effects of the CARD Act. He also described numerical, simulation-based techniques developed by macroeconomists that may be particularly well suited for policy experiments and measurement of welfare effects.

Hunt also suggested exploiting variations in effects across products, consumer segments, and geographies. Compared with the precrisis era, he noted, we have access to more and better (and less stale) data and should be endeavoring to take as much advantage of such data as possible. Still, because of the complexity of the market, any analytical approach will require some theory that can model the interconnectedness of the various moving parts of the credit contract: initial price, subsequent repricing, credit line size, score cut-offs, annual fees, and so on.

Patrick Xavier of the Curtin University Business School described international efforts to measure consumer complaint behavior. For example, European Union research revealed that of consumers experiencing problems, one in three did not complain to the supplier and, of those dissatisfied with the handling of their complaint, only 27 percent approached a complaint body and 50 percent took no actions. Research has also revealed that lower income and more vulnerable consumers are less likely to complain than others. Xavier shared that complaint data are already used in countries such as Australia, Denmark, France, and the United Kingdom to develop more focused consumer protection regulations, design effective information

campaigns, and target enforcement.

Xavier argued that “consideration of behavioral tendency should be an integral part of policymaking and regulation in consumer protection.” He pointed out that the Organisation for Economic Co-operation and Development’s Consumer Policy Toolkit emphasizes behavioral analysis on both the demand side and the supply side of the market. On the consumer side, Xavier reiterated insights from the disclosures panel: Consumers tend to apply heuristics instead of seeking optimal solutions, they stick with what they know, they follow others, they settle for good enough rather than search for the best, they procrastinate, they stick with the default option, they avoid making complex decisions, and they are prone to confusion and misleading advice.

Xavier suggested that, under certain circumstances, suppliers of credit may excessively discount the long term, seeking instead to maximize short-term returns from current customers through high prices and minimal customer service. In that context, consumer complaints may play an important role in strengthening the incentives of financial institutions to provide quality customer service and, ultimately, in enhancing competition. In order to accomplish this goal, Xavier argued that much more research is required to understand how consumers interpret and respond to the kinds of information available in published complaint data, including those now released by the CFPB. Similarly, more needs to be understood about how financial institutions respond to a “name and shame” style of complaint reporting. Finally, he

suggested it would be worthwhile to study the ways in which regulators compile and assess complaint data and use data to measure success or failure in the industry.

Ultimately, conferees and panelists agreed: We do not take enough advantage of available (or collectible) data and scientific method to inform and evaluate consumer financial protection regulations. Yet, with limited resources for both regulators and financial service providers, we cannot undertake data collection and analysis at every juncture, and we must carefully prioritize.

As Hayes shared during the panel on consumer

“Consideration of behavioral tendency should be an integral part of policymaking and regulation in consumer protection.”

— Patrick Xavier, Curtin University Business School

complaints, considerable returns have been realized in other industries by linking databases — in the form of Big Data — in order to provide more complete and complex insights and to coordinate collection. While it is certainly unclear whether industry participants, regulators, or a third party should be in charge of such an endeavor in consumer financial services, an effort to coordinate data collection and analysis could provide the vigorous and well-coordinated research effort needed for policymakers to design better and to refine consumer financial protection regulations more effectively in the United States.

APPENDIX A — GLOSSARY OF KEY TERMS

Abusive: See UDAAP in Appendix B.

Add-on rates: A method of calculating interest whereby the interest payable is determined at the beginning of a loan and added on to the principal; the sum of the interest and principal is the amount repayable upon maturity.

Behavior-based repricing: An increase in an interest rate charged on new balances based on revealed risk in behavior such as the borrower paying late or going over his or her credit limit

Covered person: An institution covered by the supervisory function of a particular regulatory agency

Deceptive: See UDAAP in Appendix B.

Downside risk: The risk of an unexpected decline in value

Penalty repricing: An increase in an interest rate charged on existing balances due to an account being 60 days delinquent

UDAAP: Unfair, Deceptive, or Abusive Acts and Practices; see UDAAP in Appendix B.

Unfair: See UDAAP in Appendix B.

Upfront pricing: Pricing that is set forth in the initial credit agreement (e.g., introductory, penalty, and cash access APR in the original credit card agreement)

APPENDIX B — KEY LAWS AND REGULATIONS

Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009

The CARD Act took effect on February 22, 2010. The act contains numerous provisions intended to curb certain industry practices that were common prior to the enactment of the act. Key provisions include:

Interest Rate Increases

- Card issuers are generally prohibited from increasing the interest rate on an existing balance unless the cardholder has missed two consecutive payments.
- Card issuers generally must give the consumer 45 days' advance notice before increasing the interest rate on new purchases. The consumer may cancel the account during this 45-day period.

Penalty Fees

- Credit card bills must be due on the same date each month. Payments received by 5:00 p.m. on the due date must be treated as timely. Card issuers generally cannot charge a late fee unless consumers are given at least 21 days to pay their bill.
- Late fees and other penalty fees must be “reasonable and proportional” to the violation of the relevant account terms. The Federal Reserve Board (Board) establishes a “safe harbor” benchmark for “reasonable and proportional” penalty fees in its implementing rule — set at \$25 for a first violation and \$35 for a second violation within the following six months.
- Late fees may not exceed the minimum payment due.

Overlimit Fees

- Card issuers are prohibited from charging an overlimit fee unless the cardholder opts in to permit the issuer to process transactions that exceed the credit limit. Opt ins are revocable at any time by the consumer, and consumers must be notified of their rights to revoke a charge any time an overlimit fee is assessed.

- Card issuers may not charge more than one overlimit fee on any one billing statement.
- Overlimit fees also are generally subject to the same limits previously outlined for late fees.

Credit Card Costs

- Each monthly statement must include the length of time it takes to pay off the bill if the consumer pays only the minimum amount due, and it must include the total cost to the consumer of doing so.
- Each monthly statement must include the payment amount necessary each month in order to pay the bill off in three years, the total cost to the consumer of making that payment, and the savings compared with paying only the minimum amount due.
- Regulations issued by the Board, which took effect at the same time as the CARD Act implementing rules, require each monthly statement to include the total amount of interest charged and fees charged year to date.

For additional details, see the CFPB's “CARD Act Report” at http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf (accessed on April 17, 2014).

Truth in Lending Act of 1968 (TILA)

TILA and its implementing Regulation Z are intended to ensure that credit terms are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably. Before the act and regulation were enacted, consumers encountered an array of credit terms and rates calculated in different ways. It was difficult for consumers to compare loans because they were seldom presented in the same format. After TILA, all creditors were required to use the same credit terminology and expressions of rates. In addition to providing a uniform system for disclosures, the act:

- Prohibits inaccurate and unfair credit billing and credit card practices
- Provides consumers with rescission rights

- Provides for rate caps on certain dwelling-secured loans
- Imposes limitations on home equity lines of credit and certain closed-end home mortgages
- Provides minimum standards for most dwelling-secured loans
- Delineates and prohibits unfair or deceptive mortgage-lending practices.

TILA and Regulation Z do not, however, tell financial institutions how much interest they may charge or whether they must grant a consumer a loan.

For additional details, see the CFPB's "Consumer Laws and Regulations – TILA" at http://files.consumerfinance.gov/f/201308_cfpb_tila-narrative-exam-procedures.pdf (accessed on April 17, 2014).

Consumer Financial Protection Act of 2010

The Consumer Financial Protection Act of 2010 was passed as Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Title X established the Consumer Financial Protection Bureau (CFPB) as an independent executive agency within the Federal Reserve System responsible for regulating the offering and provision of consumer financial products and services under federal law.

The CFPB was intended to ensure that the federal consumer financial laws are enforced consistently so that consumers may access markets for financial products and that these markets are fair, transparent, and competitive. Official authority for applicable laws and regulations was transferred from other federal regulatory agencies to the CFPB on July 21, 2011. The CFPB is led by a director with a five-year term, appointed by the President and confirmed by the Senate. The director is required to establish three specific functional units within the Bureau focusing on research, community affairs, and collecting and tracking complaints, as well as four offices: (1) the Office of Fair Lending and Equal Opportunity; (2) the Office of Financial Education; (3) the Office of Service Member Affairs; and (4) the Office of Financial Protection for Older Americans.

The CFPB has the authority to administer, enforce, and implement federal consumer financial laws, as well as the exclusive authority to enforce federal consumer

laws against nondepository covered persons (this term is defined in the Dodd-Frank Act, but it can be expanded via the rulemaking process). It has exclusive federal consumer law supervisory authority and primary enforcement authority over insured depository institutions or insured thrifts with assets totaling more than \$10 billion. The CFPB's authority over institutions with assets totaling less than \$10 billion is more limited.

The consumer financial protection functions of the Federal Reserve, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, and National Credit Union Administration were all transferred to the CFPB under Title X. Certain consumer financial protection functions of the Department of Housing and Urban Development that arise under the Real Estate Settlement Procedures Act, Secure and Fair Enforcement for Mortgage Licensing Act of 2008, and the Interstate Land Sales Full Disclosure Act were also transferred to the Bureau.

For additional details, see 12 U.S.C. §5511 at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf> (accessed on April 17, 2014).

Unfair, Deceptive, or Abusive Acts and Practices (UDAAP)

Under the Dodd-Frank Act, it is unlawful for any provider of consumer financial products or services or a service provider to engage in any unfair, deceptive, or abusive acts and practices (UDAAP). The act provides the CFPB with rulemaking authority and, with respect to entities within its jurisdiction, enforcement authority to prevent unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. In addition, the CFPB has supervisory authority for detecting and assessing risks to consumers and to markets for consumer financial products and services.

Unfair Acts or Practices

The standard for unfairness in the Dodd-Frank Act is that an act or practice is unfair when:

1. It causes or is likely to cause substantial injury to consumers.

2. The injury is not reasonably avoidable by consumers.
3. The injury is not outweighed by countervailing benefits to consumers or to competition.

Deceptive Acts or Practices

A representation, omission, act, or practice is deceptive when:

1. The representation, omission, act, or practice misleads or is likely to mislead the consumer.
2. The consumer's interpretation of the representation, omission, act, or practice is reasonable under the circumstances.
3. The misleading representation, omission, act, or practice is material.

Abusive Acts or Practices

An abusive act or practice:

1. materially interferes with the ability of a consumer to understand a term or condition of a

- consumer financial product or service
2. takes unreasonable advantage of:
 - a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service
 - the inability of the consumer to protect its interests in selecting or using a consumer financial product or service
 - the reasonable reliance by the consumer on a covered person to act in the interests of the consumer

Although abusive acts also may be unfair or deceptive, the legal standards for abusive, unfair, and deceptive are each separate.

For additional details, see the CFPB's Supervision and Examination Manual at http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf (accessed on April 17, 2014).

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— *Charles I. Plosser*
President



Ten Independence Mall
Philadelphia, PA 19106-1574
215-574-7220
215-574-7101 (fax)

www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/

Robert M. Hunt

Vice President and Director

Julia Cheney

Officer and Assistant Director

The Payment Cards Center was established to serve as a source of knowledge and expertise on this important segment of the financial system, which includes credit cards, debit cards, smart cards, stored-value cards, and similar payment vehicles. Consumers' and businesses' evolving use of various types of payment cards to effect transactions in the economy has potential implications for the structure of the financial system, for the way that monetary policy affects the economy, and for the efficiency of the payments system.