After the Great Recession: Regulating Financial Services for Low- and Middle-Income Communities†

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I. Introduction

I was asked several months ago to talk about payday lending on a television program hosted by Jesse Jackson. I've written about payday lending in the past,[1] and because I have not condemned it entirely, my initial impression was that I was expected to provide a devil's advocate perspective that would collapse under withering questioning from the Reverend Jackson. But when the show was filmed, nothing could be further from the truth. The questions he wanted to talk about were things like "Why won't banks serve our communities anymore?" and "Why do people hate payday lenders so much?" and finally, "What do our communities need to know to use this product safely?" The other guests were legislators that had adopted legislation enabling payday loans, a financial literacy expert, and Jackson's son. Ultimately, Jesse Jackson hoped the show would ease the way for payday lenders to thrive in the communities about which he cares so deeply.

When I thought about this incident over the ensuing months, I became less and less surprised. From the perspective of financial services, the low- and middle-income (LMI) communities in our great cities face disheartening challenges. Their need for

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1. *See generally* Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855 (2007) (discussing payday lending).

financial infrastructure has grown markedly during the Great Recession:

- millions of LMI households are under water on their mortgages;[2]
- millions of LMI households are mired in long-term unemployment that strains their ability to meet regular expenses;[3]
- millions of LMI households are so underinsured that they face rapidly rising out-of-pocket costs for health care;[4]
- education costs are rising at rates far in excess of inflation at the same time as pressures from globalization make advanced learning a basic necessity for economic survival;[5]
- and finally, because I like to talk about data, we have just learned from the Census Bureau's "Supplemental Poverty Measure" that the number of households in poverty has been undercounted—by millions—for the last several decades.[6]

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2. *See* Roland Li, *U.S. Underwater Mortgages Down Slightly in 3Q: CoreLogic*, INT'L BUS. TIMES, Nov. 29, 2011, *available at* http://www.ibtimes.com/articles/258084/20111129/u-s-underwater-mortgages-slightly-3q-corelogic.htm (stating that, according to a CoreLogic report, in the third quarter of 2011, the number of underwater U.S. mortgages decreased from 10.9 to 10.7 million).

3. *See* DEC. 2011 BUREAU OF LAB. STATS. EMP. SITUATION NEWS RELEASE, at 2, *available at* http://www.bls.gov/news.release/pdf/empsit.pdf.

4. *See Addressing Underinsurance in National Health Reform: Hearing of the S. Comm. on Health, Educ., Labor and Pensions*, 111th Cong. 82 (2009) (prepared statement of Sen. Sherrod Brown) (discussing the large portion of underinsured Americans and the significant out-of-pocket costs they are faced with).

5. *See Trends in College Pricing 2011*, COLLEGE BOARD, http://advocacy.collegeboard.org/college-affordability-financial-aid/trends-higher-education/publications/trends-college-pricing-2011 (last visited Apr. 6, 2012) (discussing the continuing rise in higher education costs) (on file with the Washington and Lee Law Review).

6. *See* U.S. CENSUS BUREAU, THE RESEARCH SUPPLEMENTAL POVERTY MEASURE: 2010 (Nov. 2011), *available at* http://www.census.gov/prod/2011pubs/p60-241.pdf (introducing and describing the new supplemental poverty measure and comparing it to the traditional measurement results).

As their need for financial services has grown, Congress has moved briskly to undermine the financial institutions that serve these communities, especially the community banks and credit unions on whom they depend for deposit-account services and small-business lending. Among other things, by singling out large institutions for what amounts to a federal guaranty of their obligations,[7] the Financial Stability Act[8] raises the *relative* cost of borrowing for smaller institutions,[9] which do not get that guaranty.

Similarly, closer to home for me and our topic, the Durbin Amendment[10] fixes prices for debit-card interchange at a markedly below-market level.[11] Because of economies of scale in debit-card processing, the fixed price is several multiples of the costs large banks incur in those transactions, but substantially below the costs of the typical credit union or community bank.[12] Both statutes *relatively* disadvantage those institutions. It is all but inevitable that they will close branches in areas populated by their least creditworthy customers—the LMI households about whom I am talking today.

That brings me to my topic for the day. Can we make sense of this problem? Are those who care deeply about LMI communities lashing out in the wrong direction when they complain about bank closings? Are they insane to welcome the alternative-service providers that fill the gaps the mainstream financial institutions leave behind? How, precisely, should we think about regulating

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7. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1105, 124 Stat 1376, 2121 (2010) (creating an emergency financial stabilization program that guarantees certain obligations of the largest banks).

8. *See id.* §§ 101–176, 124 Stat. at 1391–1442.

9. *See* DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD–FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 81 (2011) (explaining that large financial institutions can borrow more cheaply than smaller ones).

10. *See* Dodd–Frank § 1075(a)(2), 124 Stat. at 2068–74 (to be codified as EFTA § 920, 15 U.S.C. § 1693*o*-2).

11. *See id.* § 1075(a)(2).

12. *See* David S. Evans, Robert E. Litan & Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses* (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1769887 (last visited Apr. 6, 2012) (on file with the Washington and Lee Law Review).

LMI financial services in the post-recession environment in which we live?

I want to break this down into two stages. First, I want to discuss the modern, post-recession regulatory strategy, the Consumer Financial Protection Bureau (CFPB) being the exemplar here. Second, I'm going to explain two fundamental flaws at the heart of this strategy—its emphasis on solutions targeted at the problems of white, middle-class households, and its premise that the basic problem with financial services lies in the market interface between the financial-services firm and its customer.

II. Regulatory Strategy After the Great Recession: The Exemplar of the CFPB

The creation of the CFPB in Dodd–Frank's Consumer Financial Protection Act[13] is a breath of fresh air to academics interested in the regulatory state. Its basic function and design draw directly on academic work from successful law professors at leading institutions.[14] More importantly, the writings and public statements of those who have selected its key personnel and are most likely to influence its forward path—Elizabeth Warren, Michael Barr, Oren Bar-Gill, and Sendhil Mullainathan—suggest that its regulatory strategy will be founded directly on academic work in behavioral economics.

It is easy to see why this excites those who support the agency for more instrumental reasons—a felt need for more constraints on the providers of financial products to consumers. The trendy academic cachet of behavioral economics documents a fundamental flaw in the rational-actor model drawn from Ronald Coase's work as the foundation for traditional "Posnerian" law and economics. It turns out, if you watch carefully, that people in fact do not make fully rational decisions.[15] Indeed, if you're

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13. *See* Dodd–Frank §§ 1001–1100H, 124 Stat at 1955–2113 (creating the CFPB).

14. *See* SKEEL, *supra* note 9, at 100 (stating that the CFPB was conceived by Harvard Law Professor Elizabeth Warren, whose articles formed the blueprint for the CFPB).

15. *See* RICHARD H. THALER, QUASI RATIONAL ECONOMICS xxi (1991) ("Quasi rational behavior exists, and it matters. In some well-defined situations, people

thoughtful enough, you can make enough sense of their nonsensical behavior to characterize them as "predictably irrational."[16]

But there is more here than a "gotcha" from academics and policymakers who have grumbled under a quarter century of the austere domination of rational-actor analysis. The important thing is that the policy prescriptions that come with behavioral economics are much more satisfying to those seeking regulation than the prescriptions of Coasian doctrine as viewed through the lens of traditional law and economics. (For my part, I've never thought Coase's work lent that much support to traditional law and economics, but that's a topic for another day.) If people act irrationally, then government (at least in theory) can improve market outcomes by "nudging" them toward better choices. This is of course overtly paternalistic, but once we know we are moving people *toward* rationality, that seems easy to swallow.

So the hot subject in behaviorally benign regulatory theory becomes the selection of the proper lever for intervention—we focus on "asymmetric paternalism" that limits the considered choices of a few to improve the reckless decision-making of the many.[17]

To be sure, if you read carefully, you detect a troubling tone of insistence: if the consumers will not make the right choices, well then we will just have to make choices for them. Bar-Gill and Warren liken financial products to toasters: if we do not let Sunbeam sell a toaster that catches fire one out of a hundred

make decisions that are systematically and substantively different from those predicted by the standard economic model. Quasi rational behavior can be observed under careful laboratory controls and in natural economic settings such as the stock market.").

16. *See* DAN ARIELY, PREDICTABLY IRRATIONAL xx (revised and expanded ed. 2010) (2008) ("[W]e are really far less rational than standard economic theory assumes. Moreover, these irrational behaviors of ours are neither random nor senseless. They are systematic, and since we repeat them again and again, predictable.").

17. Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1254 (2003) (stating that "asymmetric paternalism helps those whose rationality is bounded from making a costly mistake and harms more rational folks very little").

times, why should we let CitiBank sell a mortgage that causes financial disaster for the homeowner one out of twenty times?[18]

Barr, Mullainathan, and Shafir's discussion of sticky disclosures[19] is more subtle—and perhaps more informative given Mullainathan's position at the heart of the agency.[20] They discuss guiding homeowners into a fixed-rate, fully amortizing mortgage.[21] They like that product, of course, because it avoids the risks of balloon payments and interest-rate shock. And if consumers will not choose it in the market, then they contemplate adopting ever-harsher disclosure rules for other products, raising transaction costs and the like in an effort to work ever harder to force consumers to make the choice they prefer.[22] But what Barr, Mullainathan, and Shafir do not ever consider is the cost differential between the gold-standard product they prefer and the other products in the marketplace.[23] Especially with the departure (or at least uncertainty) of

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18. *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 3–4 (2008) ("Why are consumers protected from dangerous products and sharp business practices when they purchase tangible consumer products, but left at the mercy of their creditors when they sign up for routine financial products like mortgages and credit cards?"); Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY, Summer 2007, http://www.democracyjournal.org/5/6528.php (last visited Apr. 6, 2012) ("It is impossible to buy a toaster that has a one-in-five chance of bursting into flames . . . [b]ut it is possible to refinance . . . with a mortgage that has the same one-in-five chance of putting the family out on the street . . . .") (on file with the Washington and Lee Law Review).

19. *See* Michael S. Barr, Sendhil Mullainathan & Eldar Shafir, *The Case for Behaviorally Informed Regulation*, *in* NEW PERSPECTIVES ON REGULATION 27, 43–48 (David Moss & John Cisternino eds., 2009) (proposing a sticky opt-out mortgage system).

20. *See* Maya Jackson Randall & Justin Lahart, *Harvard Economist to Join Consumer Bureau*, WALL ST. J., May 11, 2011, http://online.wsj.com/article/SB10001424052748704681904576317503890946370.html (last visited Apr. 6, 2012) (describing Mullainathan's joining the CFPB to run its Office of Research) (on file with the Washington and Lee Law Review).

21. *See* Barr, Mullainathan & Shafir, *supra* note 19, at 44–45 (suggesting a "fixed-rate, self-amortizing thirty-year mortgage loan" as a default, which consumers may then opt out of).

22. *See id.* at 46 (suggesting "a default to be offered, accompanied by required heightened disclosures and increased legal exposure for deviations" in an effort to "make high-road lending more profitable than low-road lending").

23. It bears noting that the "standard" fully amortizing 30-year mortgage is not readily available in other countries, largely because lenders regard the associated risk of opportunistic prepayment as so high to make underwriting at reasonable interest rates impractical.

government guaranties in the secondary mortgage market, the interest-rate spreads between these products and products with balloons or adjustable rates often may be so high that many consumers would be priced out of homes if they were forced into the "safe" product. (I know this sounds like an unreal concern today, but I am assuming that someday the recession will end and we will return to a "normal" housing market.)

A parallel initiative in credit-card markets, a "safe credit cards" project at the Pew Institute, is the intellectual ancestor of the "vanilla product" authority in Dodd–Frank.[24] The idea is that if banks would only issue a "safe" or standardized credit-card product, consumers with the option to take the "safe" product could retain the convenience of credit cards without being exposed to the "tricks and traps" of traditional credit-card lenders. The problem, though—to quote the old Ferengi adage—is that "there's no profit in it." The business model of modern credit-card lenders is segmentation—to identify a specific segment of the populace for which a specific targeted product is more attractive than any competing product, and thus to serve that segment with a product that (because of its attractiveness) can be priced more aggressively than more standardized products that might appeal to a larger segment of the populace.[25] The more standardized a product, the more it is "commoditized," the more easily others can copy it, and thus, the more easily they can compete on price and other terms. So the last thing any credit-card issuer is going to emphasize is a vanilla product, and the pricing an issuer rationally would put on such a product will all but ensure that it is the *least* attractive product in the portfolio.

I should mention another heartening aspect of behavioral economics as the inspiration for the CFPB: its emphasis on data and empirical work. Behavioral economics is, at its heart, an

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24. *See generally Safe Credit Cards Project*, PEW CHARITABLE TRUSTS, http://www.pewtrusts.org/our_work_detail.aspx?id=616 (last visited Apr. 6, 2012) (on file with the Washington and Lee Law Review).

25. *See* Ronald J. Mann, *Patterns of Credit Card Use Among Low- and Moderate-Income Households, in* INSUFFICIENT FUNDS: SAVINGS, ASSETS, CREDIT, AND BANKING AMONG LOW-INCOME HOUSEHOLDS 257, 258–62 (Rebecca M. Blank & Michael S. Barr eds., 2009) (describing the business strategy of market segmentation as it is used in the credit-card industry).

empirical subdiscipline: for the most part, its scholars conduct experiments designed to test the rationality of their subjects, and they write papers using econometric statistical techniques to argue that the results demonstrate significant departures from pure rationality.[26] So we have empirical papers documenting flaws in the theoretical predictions of rational-actor analysis (which has often been empirically sterile).

So it comes as no surprise that behavioralism in the policy arena has a strong data-driven flair. Thus, we have seen the Federal Reserve in the last few years conducting extensive field-testing of the disclosures it requires for consumer financial products.[27] Previously written by lawyers, in language that only the most highly specialized legal minds could hope to follow, the last round of disclosures under the Truth in Lending Act (TILA)[28] is a vast improvement in comprehensibility and functionality. Early reports from the CFPB suggest that it will be driven by the same instincts. Given the prevalence of adverse unintended consequences from regulatory intervention, this is a major step forward.[29]

The CFPB's report on remittances is a good example of how all of this can work well.[30] Presumably most of you in this audience will recall that Section 1073 of Dodd–Frank (part of the CFPA) added a new section to the Electronic Fund Transfer

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26. *See, e.g.*, ARIELY, *supra* note 16, at xviii–xxii (describing the discipline of behavioral economics).

27. *See Consumer Research Testing*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, http://www.federalreserve.gov/econresdata/consumerresearch_testing.htm (last visited Apr. 6, 2012) (providing links to reports from Board-sponsored and interagency testing of new disclosures) (on file with the Washington and Lee Law Review).

28. *See* Consumer Credit Protection Act, Pub. L. No. 90-321, §§ 101–145, 82 Stat. 146 (1968) (codified at 15 U.S.C. §§ 1601–1667).

29. To be sure, there are risks here as well, especially if the relatively ready availability of data from larger institutions motivates the Bureau to focus its attention on the activities of the larger institutions, allowing smaller (presumptively less reputationally constrained) institutions to fly beneath the Bureau's radar. *See infra* Part IV (suggesting that the largest institutions are the most likely to be law-abiding and that by singling them out for regulatory attention, Dodd–Frank takes a step in the wrong direction).

30. *See* CONSUMER FINANCIAL PROTECTION BUREAU, REPORT ON REMITTANCE TRANSFERS (2011), *available at* http://www.consumerfinance.gov/wp-content/uploads/2011/07/Report_20110720_RemittanceTransfers.pdf.

Act (EFTA)[31] regulating remittance transfers.[32] This is an important and under-studied subject, at least in part because of the importance to the recipient economies of the funds sent by these transfers. And it is also important for my work because the overwhelming source of remittances is LMI workers in this country, who are often neither citizens, nor even lawfully present in this country. So this is a group of people who will not be the target customers for heavily advertised products from the large money-center banks. The market, as it happens, is to this day dominated by Western Union.

There is much to praise in CFPB's report on remittances. For one thing, it recommends a single price metric that combines all of the various charges. In some ways, this is an old trick, reminiscent of TILA's consolidation of charges into specified disclosure categories. But the emphasis on "all-in" pricing is broader here, and reflects more of the reality of consumer choice. For products like this one, an emphasis on comparing exchange rates is no more useful than comparing interest rates on super-short-term LMI products. The real question of relevance to the purchaser is "how much money will end up in Guatemala if I give you $200 today?" A single all-in price figure is behaviorally benign (because it is easy to understand and compare), and thus feeds directly into informed decision-making.

The report also does an excellent job of facilitating price competition in a realistic way. Among other things, the report recommends facilitating online information intermediaries that would be able to provide real-time comparisons of exchange rates and related fees. (This is similar to provisions in the CARD Act[33] requiring issuers to post their credit card agreements online; Jim Hawkins here has started a project looking at some of those.) More broadly, the report emphasizes the importance of guiding

31. *See* Financial Institutions Regulatory and Interest Rate Control Act of 1978 § 2001, Pub. L. No. 95-630, 92 Stat. 3737 (adding Title IX, §§ 901–921 to the Consumer Credit Protection Act).

32. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1073, 124 Stat. 1376, 2060–67 (2010) (to be codified as EFTA § 919, 15 U.S.C. 1693*o*-1).

33. *See* Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (to be codified as TILA § 122(d), 15 U.S.C. 1632(d)).

dissemination of price and transaction information on more modern channels—mobile phones, text messages, and the like. This is a far cry from the Fed's stodgy reliance on paper-based disclosures under the EFTA, which stifle payments innovation to the present day.

III. What's Not to Like?

So what's wrong with this picture? Who could ask for anything more—an agency with an academically validated mission, a central staff including numerous informed scholars, and a cadre of experienced advocates hand-picked by the academics that brought the agency into being. My goal today is to sketch out, briefly, two fundamental flaws in the intellectual foundations of the agency. Both flaws share a single feature: a narrowing of focus that excludes much, if not most, of the relevant regulatory domain. The first is a focus on the white middle class: what we're getting is regulatory strategies designed by and for traditional middle-class households, their behavioral tendencies, and their problems. The second is a narrowing of focus to the interface between the firm and its customer: behavioral economics is a tool for improving the interactions that occur at that interface, but it says nothing about (and thus diverts attention from) anything else in society or the economy that might be relevant.

On the first point, the starting point for much of the writing in this area is the explicit premise that financial services providers use "tricks and traps" to ensnare the "consumers" to whom they provide services. We see this pervasively in scholarship about consumer bankruptcy that documents the tragic victimization of wholly innocent middle-class families beset by the unpredictable storms of a modern capitalist economy.[34] Oren Bar-Gill's work, though starkly different in its economistic

34. *See, e.g.*, Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 5 (2002) (labeling payday lenders "predators because they reap generous profits by taking advantage of consumers through means that are not only grossly unfair but, in many cases, also entirely unlawful" (citation omitted)); Warren, *supra* note 18 ("Lenders have deliberately built tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt."); Bar-Gill & Warren, *supra* note 18.

texture, is intellectually parallel: his best work shows how market forces drive credit-card issuers to design products that "seduce" consumers by playing on their predictably infra-rational behavioral weaknesses.[35]

Several points about this warrant attention. The first is the emphasis on a particular type of household. Academic work about consumer financial distress is dominated by concern for middle-class households.[36] Some of this surely is accidental, subconscious. Few academics are from LMI households; few academics at elite institutions are minorities; academics at all levels are disproportionately from the Northeast, with a substantial share from the West Coast, but few from the interior regions. So if their perspective on financial services and distress is informed at all by personal experience, it will be a personal experience that is quite narrow and, frankly, alien to my own. The narrowed focus also has a more instrumental and political basis. As we see from welfare reform, policies targeted at the middle class are more successful.[37]

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35. *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1376 (2004) (calling the credit card "a tool designed to exploit consumers' underestimation bias" and stating that "if the credit card market is as competitive as it appears to be, insurers *have to* exploit consumers' imperfect rationality in order to survive in this market").

36. *See, e.g.*, TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 27 (2000) (stating that "bankruptcy is a middle-class phenomenon"); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 10–11 (1999) ("At an early point in this project . . . the income figures made us believe that bankruptcy was being used almost exclusively by the lower middle class as a safety net from poverty."); ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS PARENTS ARE GOING BROKE 194 n.12 (2004) ("Among families in bankruptcy, 92 percent include [someone] who completed at least some college (57 percent), held a job in the upper 80 percentile of occupational prestige (70 percent), and/or owned a home (58 percent). Two-thirds . . . met two or more criteria, and 27 percent met all three." (citation omitted)); Elizabeth Warren, *The Growing Threat to Middle Class Families*, 69 BROOK. L. REV. 401, 405 (2004) (stating that most of those families that end up in financial trouble, including bankruptcy, "are ordinary, middle-class people united by their determination to provide a decent life for their children").

37. *See, e.g.*, MARTIN GILENS, WHY AMERICANS HATE WELFARE (1999); LANE KENWORTHY, PROGRESS FOR THE POOR (2012).

Collectively, the narrowed focus plays elegantly into the classic neoliberal regulatory strategy: using paternalistic intervention to correct market imperfections.[38] The strategy works best on those who are "like us" because we understand their needs and limitations best. There is, in a way, a "shared" sense of what counts as good decision-making when we focus on the financial services and choices that confront the middle class: we can understand their needs, we can recognize what mistakes they might make, and we can see from above how to substitute our better choices for theirs. What we need, then, is a regulatory frame that is based on a socially realistic model of consumer financial activity.

The existing literature, as well as ongoing work by several people, affords a lot of guidance. John Caskey's work on fringe banking sets the perfect tone here, explaining that one reason LMI households use pawnshops and check-cashing stores instead of banks is simply that they are cheaper than the alternatives available to them.[39] This is an important point, because the victimization thread of the neoliberal strategy rests on the explicit premise that the poor are simply not capable of taking care of their own money.[40] It is only a slight caricature to say that the highest aspiration of the financial literacy scholarship is to get the poor to come to more seminars about how to calculate compound interest because we know that *then* they will be smart enough to avoid high-cost financial products.[41]

But there is a burgeoning empirical literature suggesting that households that use alternative financial services are in fact

38. *See* DAVID HARVEY, A BRIEF HISTORY OF NEOLIBERALISM 64–81 (2007) (describing the neoliberal tendency to favor state intervention over market independence and democracy in matters such as protection of financial interests).

39. *See* JOHN CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 84–110 (1994) (discussing reasons why low- and moderate-income households are driven from bank accounts to fringe providers).

40. *See id.* at 9 (describing some common criticisms of LMI households who patronize fringe banks).

41. *See* Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Planning: Implications for Retirement Wellbeing* 16–17 (Nat'l Bureau of Econ. Research, Working Paper No. 17078, 2011), *available at* http://www.nber.org/papers/w17078 (discussing the correlation between financial literacy, determined by familiarity with interest compounding and inflation, and retirement planning).

pretty good managers of their money. Stango and Zinman, for example, show that LMI households do an admirable job of balancing use and payments among the various credit accounts they hold.[42] Similarly, work by Bertrand and Morse (and preliminary results from an ongoing survey in which I am involved) suggests that payday-lending customers have a surprisingly accurate understanding of how they will use the product.[43] Most of them expect to roll over their loans, and their estimates of how long they will continue borrowing are surprisingly accurate.[44] So it is simply not right to say that they are borrowing because of an unjustifiably optimistic view that they will somehow come up with funds to make themselves debt-free by their next payday.

Seen through that lens, I think we have to accept, notwithstanding the high costs, that one reason households are choosing payday loans instead of credit cards and fixed-term bank loans is that they make more sense for them *in their milieu*. For one thing, they are a lot easier to understand than credit cards: the charges on payday loans are collected up front, typically in one single fee, of which the customer is aware before leaving the counter.[45]

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42. *See* Victor Stango & Jonathan Zinman, Borrowing High vs. Borrowing Higher: Sources and Consequences of Dispersion in Individual Borrowing Costs 22–23 (Nov. 2011) (unpublished manuscript), *available at* http://www.aeaweb.org/aea/2012conference/program/retrieve.php?pdfid=443 (finding that most borrowers allocate debt and repayments to their lowest-rate card or cards, and that misallocation explains little of the variation in borrowing costs) (on file with the Washington and Lee Law Review).

43. *See* Marianne Bertrand & Adair Morse, *Information Disclosure, Cognitive Biases and Payday Borrowing* 17–18, 34 (Univ. of Chi. Booth Sch. Of Bus., Working Paper No. 10-01, Oct. 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1532213 (discussing some of the cognitive mistakes payday borrowers make, and stating that payday borrowers do have cognitive biases that lead to mistakes in decision making, but suggesting that these biases and mistakes may be less common than many assume them to be).

44. *See id.* at 18 (comparing actual repayment time with people's expectations of repayment time and stating that, although there was substantial variation, the mean estimate was close to the correct answer of five to six weeks).

45. *See id.* at 16–17 ("In contrast to other subprime lending, payday lending is widely believed to be a fairly transparent transaction: payday borrowers must all realize that the loan costs $17 per $100 of borrowed funds.").

Who among us knows exactly what the "all-in" costs of borrowing are on any of the credit cards we so routinely pull from our wallets? Even assuming (with the kind of optimism we scoff at in LMI households) that we always pay all of our bills in their entirety, every month, do we really remember which cards have annual fees, how much they are, what the rewards are that offset the fees, and how likely it is that we will, in fact, use those rewards? I would make a strong case that the LMI households know a lot more about the fees they pay to financial institutions than most academics do. That makes some sense, if you want to talk about the declining marginal utility of money and the opportunity cost of our time: I am sure I have good reasons for ignoring those things. But that just makes the point even more strongly: there are good reasons to think that less well-off households, for whom the marginal dollar is *really* tight, *should* pay attention to those fees, and the products they are choosing are not so obviously inconsistent with their capability to do that.

A related point is the relative risks of the products between which households choose. It is a common assumption in the financial-literacy literature that LMI households borrow from payday lenders when they have unused credit available on credit cards.[46] But from the LMI perspective, this makes *perfect* sense. I will offer two different strategies.

- First, if we want to discuss the long-term risks of a product, entanglement in long-term borrowing is an important concern. Here, payday loans are far less perilous than credit cards. As I have written before (with Jim Hawkins), payday loan balances are self-limiting.[47] The payday lender is not going to lend beyond the amount of the next paycheck—and not often beyond half of that amount. The credit-card lender, by contrast, readily will lend a substantial fraction of a year's salary, and in times of distress,

46. *See generally* Summit Agerwal, Paige Marta Skiba & Jeremy Tobacman, *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?*, 99 AM. ECON. REV. 412 (2009).

47. *See* Mann & Hawkins, *supra* note 1, at 886 (noting that "unlike credit card lending, payday lending has a limited potential to spiral into escalating levels of borrowing").

might hold a debt exceeding a year's salary.[48] To be sure, this rationale might support information-based reforms that make it harder for borrowers to stack payday loans from multiple providers, or federal intervention to control internet payday lenders that help avoid state regulations on those issues, but those problems seem to be a detail in the larger picture.

- Second, rational borrowers would regard open credit-card lines as a valuable store of liquidity. Indeed, qualitative data suggest that they regard the unused credit as an asset in the same way a middle-class household would view a savings account: something stored up to be drawn down only in an emergency. But from the LMI perspective, this is wholly sensible. The great value of the credit-card lender is the likelihood that the credit-card lender will extend funds to you even *after* the adverse shock (loss of employment, etc.) that would scare off other lenders (banks, or even payday lenders). So the prudent household would precommit to "saving" the credit card line for the direst of emergencies.

The final point here is a little harder to pin down, but probably the most important of all: the members of LMI households, for various reasons, simply do not like banks. They do not trust them to be fair. They do not trust their products to be transparent. They are not comfortable going into their branches.[49] The banks have brought this on themselves to a large extent, with the competition-driven frenzied rush to identify new and ever-more particularized streams of fee income. The backlash about overdraft fees, culminating in the recent amendments to Regulation E restricting those fees,[50] is only the most obvious

48. *See* Allison Mann, Ronald Mann & Sophie Staples, Debt, Bankruptcy, and Life Course Mobility 13–14 (Nov. 2010) (unpublished manuscript) (discussing a regression estimating the relation between household income and credit-card debt) (on file with the Washington and Lee Law Review).

49. *See, e.g.*, Marianne Bertrand et al., *A Behavioral-Economics View of Poverty*, 94 AM. ECON. REV. 419, 420 (2004); Luigi Guiso, *A Trust-Driven Financial Crisis. Implications for the Future of Financial Markets* (European Univ. Inst., Working Paper No. 2010/07).

50. *See* Regulation E, 12 C.F.R. § 205.17 (2011).

example. But whatever the cause, it gives that share of the market a baseline preference for the product that *does not* come from a mainstream financial institution.

The salient data point here is Walmart: Americans that are not wealthy like buying things from Walmart. They know what they are going to get: passable quality and unimaginably low prices. So when Walmart sells financial services, consumers are attracted because they assume that prices will be low and that they are not going to be tricked. Some might think that $3 to cash a paycheck is a lot when we can deposit checks for free with an app on our cellphones. But to the customer that cashes checks at Walmart instead of investigating opening a bank account the choice is easy. He *knows* he is only going to spend $3 a month, and he is going to be at Walmart anyway. To open a bank account, first he has to go to a bank, which is not fun or convenient. Then, he has to hope that he can find an account that will let him get his money without additional fees, which in truth is pretty unlikely. Then, he has to think about the likelihood that, even if the account sounds good when he signs up for it, he will end up paying a lot of fees that the bank hid from him, made up after the fact, or simply cheated him out of. I am still sure I was right when I wrote several years ago that the best thing we could do for financial competition would be to let Walmart have a bank.[51] But of course we did not do that, so we are still stuck with the kind of banks we had before the recession. In the end, when it comes down to it, it is no different now than it was when Caskey wrote: the smart ones do not even try going to banks.

Turning now to my second main point: a great deal of LMI households' financial problems come not from mistreatment by financial services providers, but from the more basic problem that LMI households often face chronic money shortages. *The problem is that they are poor.* This sounds tautological, but it links up to the most fundamental flaw with using behavioral economics as the base for regulatory strategy. The basic problem is that embracing behavioral economics implicitly embraces the underlying assumption that what is wrong with financial

51. *See* Ronald J. Mann, *A Requiem for Sam's Bank*, 83 CHI.-KENT L. REV. 953, 956 (2008) ("[A] powerful case can be made that granting Wal-Mart's application would have had a salutary effect on a market that has seen too little competition and innovation for the last two decades.").

services—what needs to be fixed—is the interaction between the customer and the firm. If we could only get "consumers" to choose the "right products," then we would return to a golden age of well-considered use of financial products.

But to state this as the premise is refutation enough. The false dichotomy is between rational-actor models—the contracts must be efficient because they exist—and behavioral models—the contracts cannot be perfect, because predictably irrational consumers agreed to them. The correct dichotomy is between "fixing the market" (the narrow-focused economic approach) and a broader approach, founded on the idea that the role of government is to supply appropriate market-supporting institutions. To turn this around, if we think that LMI households would suffer financially even if they made perfectly rational choices among the financial products available to them, then neither of the rational-actor or behavioralist strategies is constructive. Indeed, the seductive power of the behavioralist strategy is its promise of activist regulators, intervening aggressively to solve important problems. But in truth, I suggest, the main effect of that strategy is to divert attention from real solutions to the real problems that plague LMI finances. What we need to do is help them with the difficulties of being poor, not pretend that their poverty is irrelevant to their financial choices.

In some respects, this is the point where my presentation falls apart, because many of the sources of economic dislocation that I summarized when I began are so far removed from the financial services industry as to be completely beyond my ken—rapidly rising expenses for education and health care, increasing rates of employment turnover, and plummeting real-estate values that leave households locked in to insupportable and unrealistic mortgage payments.

There also is the problem that my dichotomy between firm/customer problems and broader market problems is arbitrary, given the situation of both firms and customers in that market, and the close relation between that market and the products firms can market successfully to households. But having said that, and acknowledging the overlap with the discussion above, I want to flesh out a few more points that seem to me too broad to situate appropriately within the narrow behavioralist frame of the product-centered firm/consumer interface.

The most important one is the surreal perception of consumer budgeting that dominates the perspective of academics and financial literacy advocates. Implicit in the analysis of the "debt trap" of payday borrowing[52] is the treatment of the transactions of customers that enter a cycle of payday borrowing as making a large loan at the beginning of the cycle, and steadily saving up, little by little, until they have collected enough funds to repay the loan. Then, looking at the interest rate for a loan of that term, they conclude that alternative products with an equivalent term could have served the borrower's long-term borrowing needs much less expensively.

But I want to suggest that this fundamentally misapprehends the reality of distressed households' extremely short time horizons for financial decision-making. I envision these households, based on the interviews I have done on various qualitative projects, as living their financial life almost literally "from day to day," sorting expenses during each pay period based directly on the creditor's threat point: what will happen if I do not pay this expense out of this paycheck? Is it worse to let the light bill go 60 days behind or the credit-card bill 120 days behind? (Answer: light bill, because the utility company might actually turn off the electricity.) Is it worse to forgo repairing the car or borrow for the fourth pay period in a row from a payday lender? (Likely answer: Repairing the car, because if you miss work again you will be fired.) Behind all of this is the reality that the household will stop visiting the payday lender *not* when it has saved up enough money to pay back the loan; it will be repaid when a pay period comes that does not involve any expense important enough to trump the benefits of savings the $45 fee that comes from borrowing $300 this month.

Among other things, this picture suggests a considerably different view of rollovers and repetitive borrowing than much of the literature.[53] It is just not a useful question to ask whether we should stop these people from borrowing because they do not

52. *See, e.g.*, Uriah King & Leslie Parrish, Springing the Debt Trap: Rate Caps Are Only Proven Payday Lending Reform, CENTER FOR RESPONSIBLE LENDING (Dec. 13, 2007), *available at* http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf.

53. *See, e.g.*, Johnson, *supra* note 34, at 55–77 (describing rollovers and the problems associated with them).

understand the high interest rates they are paying. There is no doubt, for at least a large group of these families, that the all-in costs of borrowing are dwarfed by the opportunity costs of what they would lose if they did not borrow. If we stop their borrowing, we will simply drive them directly into the loss of that far more costly opportunity—the lost job or cut-off utilities they used the loan to avert.

The relevant question is the much harsher, less comfortable one: should we stop them from borrowing because we all would be better off if they fell off the financial cliff and filed for bankruptcy today, instead of borrowing and struggling indefinitely in a Dickensian effort to find the silver cloud that is always "just around the corner?" I for one know very little about the trajectories of these borrowers: after borrowing repetitively for months, how many of them eventually fail, and how many eventually recover? For how long do they stagnate in the cycle of repetitive borrowing? And, in the end, how likely is it that their situation would improve even if they did use bankruptcy to get a completely fresh start? If we knew the answers to these questions, we could formulate a sensible intention to nudge (or force) them away from (or toward) these products. And if we wanted to nudge them toward these products (because we decided that a large enough group used them to come out the other end of the tunnel), we would want to figure out how to make the products more accessible, not less—ways to use regulatory design to facilitate price competition that could nudge the price downward rather than regulatory hostility to drive effective prices upward.

IV. Challenges

So where does this lead? These are transparently intractable questions. I hardly even have intuitions about how to answer these questions, and investigating them would be a challenge even for a skilled and well-funded academic. But it does, I think, suggest a number of things both for regulators and academics.

For one thing, if the CFPB aspires to improve the lot of those that use the products it regulates, it is crucial that it move beyond the "flaming toaster" model of regulation. Fixing the product will not help anybody if "fixing" is functionally the same as banning, and if the product is the best alternative available to consumers. If the agency wants to do justice to its academic roots it has to take a broader perspective, situating the products in the institutional settings in which they are embedded and assessing the real effects of regulation on the broad menu of choices available to households. That may require new rounds of behavioral research, attempting to understand how the cognitive landscape that shapes the choices of those that use "fringe" financial products.[54] And in truth I don't think the questions I pose above are intractable for an agency with the data-collection powers the CFPB will have if and when it has a director.

And let me close with two other sets of questions that this framework raises. First, much of the focus of policymakers since the days of John Caskey's work is on bringing LMI households into mainstream financial institutions. Our central questions focus on how many of them have bank accounts and use the same products as the middle class. I wonder if that is the right goal. If we accept the reality that households of greater financial instability have different sets of constraints and needs, maybe they need a different sort of financial institution: if it is so hard for banks to profit from serving these households, maybe we should try to foster other institutions that might serve them. We have heard for decades that "the poor pay more," and that certainly is true in a lot of ways. But we are not all that upset that Walmart serves a different demographic than Target, and nobody is ever complaining that the poor pay more when they go to Walmart. So instead of spending so much time stamping out the Walmarts of the financial world, maybe we should try instead to bring them within the tent of "favored" financial providers—coopting them to the mission of legitimacy instead of pressing them to the edge of illegality.[55]

As the discussion above should make clear, Dodd–Frank is a step in exactly the wrong direction. In this particular sector, it

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54. I am working on such a project already, investigating the extent to which optimism bias afflicts the borrowing decisions of payday loan customers.

55. *See* Mann & Hawkins, *supra* note 1, at 905–12; *cf.* Sharon Collard, Anna Ellison & Rob Forster, *Illegal Lending in the UK*, POLICIS (Feb. 2006), *available at* http://www.bris.ac.uk/geography/research/pfrc/themes/credit-debt/pfrc0707.pdf.

has singled out the largest institutions for regulatory attention for which small actors will be exempt.[56] There are obvious reasons for limiting supervision to the largest actors, but in an industry where there is reason to think that the largest actors are the most likely to be law abiding,[57] there is a distinct element of perversity in tilting the playing field to put those actors at a particular disadvantage.

The second question, related to the first, is why do we have a regulatory model that forces short-term lending for the truly distressed into the two-week payday model? The existing regulatory system pretty much limits anybody who wants to do lawful, short-term lending to the two-week full-payment model tied to the historical roots in check-cashing of the product's inventors. But there is nothing about the market other than the legal framework that forces them into that product, which consumer advocates hate so much: given the chance, I am convinced that the same lenders could profit on a product with a term of a few months instead of a few weeks, with a much lower interest rate (because of lower transactional costs per month of outstanding loan). I strongly support a project like the Russell Sage initiative that led to the small-loan laws almost a century ago[58]—a genuine collaboration among regulators, consumer advocates, and lenders focused on a goal of facilitating small-loan lending at the lowest practicably profitable rates by licensed and transparent lenders.[59] I am convinced we could develop a product that would serve the backstopping needs of the poor much better than the existing products, with revenues sufficient to attract

56. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1024(b)(2), 124 Stat. 1376, 1987–88 (2010) (instituting CFPB regulatory supervision of the largest payday-loan provider).

57. It seems even more likely now than when I wrote with Jim Hawkins several years ago to be the case that the Internet-based and tribe-affiliated lenders that are effectively beyond the reach of the state regulators play an important role in the market, especially in states in which regulation of payday loans substantially constrains the provision of the product. *See* Mann & Hawkins, *supra* note 1, at 868–71 (discussing Internet providers of payday loans).

58. *See* ROBERT MAYER, QUICK CASH: THE STORY OF THE LOAN SHARK 45–46, 73–74 (2010) (noting the role of the Russel Sage Foundation in leading efforts to draft what became the Uniform Small Loan Law).

59. *See id.* at 176–77 (noting the lack of a modern-day equivalent of the Russel Sage Foundation in the context of payday lending).

legitimate lenders. It would still bear an interest rate far above traditional usury ceilings, but if we face up to the reality of the situation, I think we could design something that fits their needs more directly, far more cheaply, and with a far lower risk of illegal lending than the existing statutory system.