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A Legal/Economic Analytic Framework for the Regulation of Consumer Credit Transactions

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Abstract

Consumer transactions of all kinds are heavily regulated in the US (and all other developed capitalist countries) but debates on regulation in the US are dominated by de-contextualized argument-bites, such as “you are hurting the people you are trying to help” and “free markets are presumptively best for growth.” This paper presents, schematically, some typical responses. There are efficiency arguments for regulating transactions that impoverish consumers, because of cognitive deficits, competitive races to the bottom, and/or price discrimination. There are arguments for the distributive desirability of regulation, first as between consumer and supplier, then as between consumers (the important domain of cross-subsidies) and finally as between suppliers and the victims of negative neighborhood effects of non-regulation. Regulatory decisions are made with inadequate or non-existent data and are heavily influenced by the political orientations of decision-makers. .

Bulleted Outline

I. In the US and every other capitalist country, consumer transactions are already regulated in multiple and highly variable ways, as for example:

--mortgagors have a right to cure defaults at the last moment before foreclosure, regardless of contract disclaimers

--buyers of goods on credit (e.g., automobiles) have right to refuse payment for defective goods, regardless of contractual agreement that the financial institution that has bought the loan is a "holder in due course."

--there are limits on charges on lost or stolen credit cards even before the loss is reported, and even where the cardholder has agreed to pay in full.

II, Highly stereotyped arguments, put forward more or less regardless of the circumstances, oppose consumer protection

--"hurting the people you are trying to help"

--protection increases costs to sellers and therefore will reduce supply ("regulating banks will reduce the availability of mortgage credit")

--consumers will pay more ("regulating banks will increase interest rates")

--"consumer protection is paternalistic"

--right to contract for any term you want, and should accept responsibility for free choices ("if I want the product without a warranty for a lower price, that's my business")

--people are the best judges of their own interests (more mild: people can judge better than the government what is in their best interests)

--banning a term denies it to buyers for whom it is rational, cross-subsidizing less competent people who should have known better ("no initial interest loans with balloon payments are right for some borrowers, so shouldn't be banned across the board")

-- "free markets are more efficient and lead to more growth than regulated markets" (ludicrous but common)

II. Generic efficiency arguments in favor of regulation, beyond the argument for regulating monopolies

--***curb transactions that impoverish the consumer***

--***marginal cost pricing with cognitive deficit***: unregulated transaction not welfare enhancing because consumer systematically and predictably over-estimates the value of the product

--never welfare enhancing taken as a single transaction (all the goods are bad for the price)

--not welfare enhancing for consumers as a class because they pay more than they receive (some consumers benefit, but net loss for the group)

--non-disclaimable product warranty raises price, shifts demand to substitutes, but raises quality, so that transactions are welfare-enhancing

--***competitive race to the bottom on terms of transaction***: consumers cognitively unable to compare mortgage terms, buy on the basis of price, forcing all sellers to disclaim all possible duties in order to retain market share

--price equals marginal cost on assumption of worst possible terms for consumer

--with those terms the transaction is impoverishing for all, or for consumers as a class

--compulsory terms restore welfare enhancing competitive pricing

-- curb transactions where the consumer pays more than marginal cost, because of ***price discrimination***

--"shoppers" who compare sellers are in an isolated pool, most buyers transact without comparing price or terms

--the upward limit on price comes from the substitution effect (the more the monthly mortgage payment the less is available for food, etc.)

--extreme case: card company computer data isolates pool of cardholders who will take price increases until they go bankrupt

--regulation forcing terms toward marginal cost cures inefficient over-allocation of consumer resources to credit, permitting re-allocation to higher valued uses

IV. Generic distributive arguments in favor of regulation

--desirable distributional effect ***as between consumers and sellers*** of curbing welfare-reducing and above-marginal-cost transactions

--regulation forces price increase, reduces sales, reduces value of equity and surplus available for compensation

--while enhancing consumer welfare viewed ex post

--possible desirable distributional effects of ***cross-subsidies among consumers*** that favor poor consumers at the expense of rich ones

--where the protective term is worth more to consumers as a class than it costs, it functions as compulsory consumer insurance against transactional failure, at a single price to all, generating cross subsidies within the pool (avoiding possible adverse selection and moral hazard),

-- possibly structured to benefit poor consumers at the expense of rich ones (examples of products liability and health insurance)

--prevention of distributionally undesirable ***neighborhood effects***

--US neighborhoods highly segregated both by income and by race

--foreclosures, car repossession, consumer bankruptcy concentrated by income and race, and therefore by neighborhood

--strong interdependence of housing values within neighborhoods with effects of level of re-investment (maintenance, etc.) as well as sensitivity to events like foreclosure means neighbors lose

-- adverse distributional consequences of regulatory failure can trigger downward neighborhood spiral

V. Both regulatory and anti-regulatory decisions have to be made on the basis of inadequate date, and under those circumstances the above arguments will be given dramatically different weight according to the political orientation of the decision-maker.

Introduction

In this paper, I present a legal/economic analytic framework for policy choices about "compulsory terms" in consumer contracts, and in particular consumer credit contracts.

The terms mentioned in the bulleted outline above, the equity of redemption, the disallowance of "holder in due course" status for purchasers of chattel mortgage debt (car loans), and the banning of charges for fraudulent purchases on stolen credit cards, are all examples. The term is also called a non-disclaimable duty, because courts and administrators will treat it as present and enforceable, even if the seller and consumer have explicitly provided in the contract that the seller has no such obligation.

A good number of the conceivable reforms of consumer credit in the aftermath of the crisis fall into the category of compulsory terms. For example, the prohibition of various up front fees to brokers and originators, without imposing overall interest caps, is a compulsory term Likewise barring balloon payments, no initial interest loans, particularly tempting or deceptive variable rate clauses, etc.

A wide variety of compulsory terms are already present in consumer contracts of all kinds. Some important examples are non-disclaimable product warranties against physical injury from defective products; the non-disclaimable right of a residential tenant not to be evicted by the landlord until the landlord has obtained a court order; the non-disclaimable right of patients to recover for malpractice-caused injuries; the non-disclaimable right of an insured to recover in spite of non-material false statements in the insurance application; and many many more.

It is important to understand that many, probably the majority of compulsory terms in consumer contracts have been created by regulatory agencies, rather than by courts or legislatures. This is true of the whole area of public service contracts, including utilities, insurance, transportation, etc. For retail banking, the Fed does the regulating, deciding what terms covering, for example, bounced checks, stop payment orders, and overdraft credit, banks can include in contracts with consumer depositors.

Overall, it is fair to say that the average consumer engages in very few transactions that are not subject to one kind or another of compulsory term. Nonetheless, compulsory terms are only one part of the regulatory apparatus for consumer transactions. Three other important

regimes are price fixing schemes, most prevalent in the public service corporation sector, compulsory disclosure schemes (truth in lending, securities regulation) and government standard- setting, testing and inspection regimes, most prominently for food and drugs. Each of these requires its own legal/economic analytic.

What distinguishes the sub-set of compulsory terms I will discuss is that they are "insurance-like." By this I mean that they require the seller either to make a payment, or to forego a profit maximizing action, when a contingent future event occurs. The easiest case for the analogy between a compulsory term and a compulsory insurance regime (e.g. compulsory auto liability insurance) is products liability. Here, the seller of the product will have to make cash compensation to buyers injured by product defects, even if the sales contract solemnly declares that the consumer is buying "as is," and fully assumes the risk of product defects in exchange for a lower price.

Debtor protection regimes resemble products liability in this way: the creditor is prohibited from taking an action that would be in its economic best interest, but would disadvantage the debtor, even if the debtor has explicitly agreed in the loan documents to expose himself or herself to this kind of action. The residential mortgage debtor cannot make an enforceable agreement, for example, not to redeem the property, before it is sold at foreclosure, by paying the balance owed plus interest. In many states, the debtor cannot agree to make a residential mortgage "with recourse" against his personal assets in the event the house is worth less than the loan.

Still analogous to compulsory insurance, although a little less obvious, is the prohibition of forfeitures. The debtor cannot make an enforceable agreement, for example, to forfeit his equity to the creditor in the event of default. The court will ignore the agreement when the creditor tries to enforce it, even if at the moment of taking out the loan the debtor considered such an agreement well worth it, given that in return the lender substantially reduced the interest rate.

In each case, because the term that benefits the lender, or the exemption of the lender from liability, is unenforceable, the transaction is less profitable than it would otherwise be. (Supposing, of course, sometimes counter-factually, that enforceability in court is an important determinant of the ability of the lender to get the benefit of the term.) It was because the unenforceable term would have made the transaction more profitable that the lender was willing to reduce the interest rate in return for the borrower's agreement to it.

From this last point starts the legal/economic analysis of compulsory terms that has developed in the legal literature over the last thirty-five years or so (with surprisingly little attention paid, let it be said, by economists). [1]

This paper tries to add to this literature by focusing on a point usually made by critics of compulsory terms: that they cost the seller, so that they shift the supply curve up and to the left, causing some consumers to be priced out of the market and others to pay for something they would not purchase without compulsion.

Exactly because the sellers can and do develop concrete quantitative information about how much the term has cost or will cost, it is possible to ask the following questions:

1. are the consumers who are priced out of the market by the price increase (caused by compelling the term) better or worse off than they were in the old unregulated market, given that (a) they have to buy a less favored good, but (b) avoid the losses, associated with the unregulated good (e.g. loss of equity in foreclosure), that the new term guards against?

2. for consumers who would not voluntarily contract for the term, but now choose to pay for it in order to get the underlying product, is what they get in benefits, or avoided losses when the contingent event occurs, more or less, in dollar terms, than what they paid for it?

3. what are the distributive consequences, as between sellers and consumers, and among consumers with different income and risk characteristics, of the imposition of a compulsory term, or in other words, what cross-subsidies result from regulation?

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[1] The main contributions: Leff, Ackerman, Markovits, Posner, Schwartz, Ackerlof, Schill, Crasswell, Hanson, Ayres, Jolls, Jolls/Sunstein/Thaler.

Part One: Excluding consumers from the market

A. When is exclusion justified? The case of welfare-reducing transactions

It is a common intuition that it is justifiable to impose a term that will force some consumers out of the market only under certain conditions.

The analogy between a loan and a defective product

The simplest fact situation often regarded as justifying exclusion is that of defective products that cause physical injury, for example contaminated food. Suppose that there is a class of ill informed or inattentive or just unwise consumers who will buy the product, say, the contaminated food, if it costs less than a superficially identical safe version of the good. Imagine that it is also certain that the product is defective in the very strong sense that no informed and attentive consumer would buy at the reduced price, given just how bad the defect is.

The analogy to consumer credit supposes that there is a class of ill informed, inattentive and/or unwise borrowers, in the home mortgage, car loan, credit card and payday loan categories, who will take on levels of debt that are certain to be unaffordable, and to lead to bankruptcy, foreclosure, or other loss of assets. Assume that any wise, informed and attentive borrower who understood the terms offered at the claimed low price would forego the loan. (The unwise borrower will tell the newspaper that "The monthly payments turned out to be more than my whole monthly income!")

The alternative safe version of the product, declined by our consumer, has a greater marginal cost. If we ban the defective product (or loan instrument), or impose an enforceable compulsory warranty of quality, the sellers of the defective product will discontinue it. Their customers will either leave the market, or buy the alternative, more expensive non-defective version of the product with the warranty, whose sellers have no reason not to remain in business.

The buyers forced out of the market spend the money they save on the next most favored good, and presumably gain less ex ante consumer surplus from that good than they would have gained ex ante from the discontinued defective item. For most products, there exists a fairly smooth continuum of alternatives. In the housing market, however, if the defective good is a mortgage loan, for a household moving into home ownership for the first time, the ex ante difference might be large. For example, the ex ante benefit of spending the saved money on a

better rental residence, without equity accumulation or long term security of tenure, may be quite a bit less than the (mis)perceived ex ante benefit of the foregone mortgage.

The excluded consumers benefit from exclusion in that they no longer suffer the losses – say, sickness resulting from the contaminated food, or foreclosure and loss of their equity due to assumption of unaffordable debt. It is hard to imagine that the consumer saved in this way from the consequences of ill informed, inattentive or unwise behavior would complain that they were worse off than if they had been allowed to buy the defective product.

Generalizing the welfarist test for exclusion

There is a strong case that it is all right to exclude: (a) if the excluded consumers will be better off as a result; (b) other consumers will not be worse off as a result; (c) sellers' only losses are from lost sales; and (d) the cost to taxpayers of enforcing the compulsory term are small.

Adding b, c, and d, makes this test close to one of Pareto optimality, in other words, of efficiency in the strong sense rather than the watered down Kaldor/Hicks version. (I will flesh this out in the next section.)

Of course, there may be an excellent case without all the conditions being fulfilled, as I will elaborate as soon as I've dealt with a common further argument against compulsory terms.

The "rights-moralist" critique of the welfarist test

There is a body of opinion, getting quite a bit of play these days in the Wall Street Journal and the op ed columns of David Brooks, that would add a further condition. Even if the cost of enforcement is small, the public should not bear it, in this view, if we regard the purchasers who will be priced out of the market as at fault, for being unwise or failing to inform themselves or to pay attention. In the strongest version, even where there is no fault on the part of the consumer, there should be no government action to interfere with freedom of contract between sane adults, unless the seller offering the disastrous bargain is guilty of actively misleading or coercing the unfortunate buyer.

The proponent is likely to add that "bailing out" consumers through government intervention, such as interference with freedom of contract, is likely to make the problem of consumer fault worse rather than better. It eliminates the bracing incentive to look after yourself that comes from having to suck up the consequences of your mistakes.

The debate about compulsory terms gets a lot of its complexity from the combination of the "welfarism" of the first part of this test with the rights-oriented moralism of the second part. The welfarist arguments are not responsive to the rights-moralist ones, and vice versa. My purpose here is to offer a typology of arguments rather than to settle arguments. For this purpose, I think it is important to have in mind the usual response to the argument that in any particular case the buyer is at fault.

The "situationist" response to rights-moralism[2]

We explain the unwillingness of consumers to pay the cost of a safe product through a wide variety of categories: the consumer may be ill informed or inattentive, but the more interesting categories I bundled above as "unwise." Three prominent elements would be:

(a) steep time preference, meaning a heavy discount of future losses as compared to the present benefit of the lower price;

(b) risk preference, meaning a large discount of uncertain future losses, such as for example being unable to meet monthly payments;

(c) cognitive distortions of the type now elaborately documented in the behavioral economics literature.

So long as there are consumers who share some of these traits, there will be a (competitive) market selling (at marginal cost) products and financial instruments that, we can predict with confidence, will make buyers worse off ex post than they would have been, if we had priced them out of the market by imposing a compulsory term. That the pool exists, and the market that supplies it, is simply a fact.

Empirical research has established more and more convincingly that consumers in the market for credit suffer particularly seriously from all these kinds of informational and cognitive deficits. Against the rights/moralist position, it appears that these disadvantages are situationally determined.

[2] Jon Hanson.

This means that actors who are informed, attentive and wise in some situations are, completely predictably, the opposite in other situations. Their behavior flows from the setting rather than from their different individual traits of character. Moreover, and this is crucial for the critique, what differences are predictable on the basis of the traits of the actor rather than of the situation, are tightly linked to indicia of class, namely income, education and occupation. In other words, even individual differences are best explained by earlier situational factors over which the actor had at the time only minimal control (class is largely determined by birth). Finally, there is yet another important situational influence on the consumer incapacities condemned by the rights-moralists, namely the promotion of a present oriented materialist culture, along with exaltation of an illusory consumer autonomy, by the seller interests now moralizing consumer errors.

For the situationist enemy of the rights-moralist, this means that compulsory terms can only rarely be effectively criticized for rewarding vice at the expense of virtue. The elements of the welfarist test will generally be what counts in the policy analysis of limits on freedom of contract. To these we now return.

What if some of the excluded would have benefitted?

In my first example, all consumers who bought without protection were losers as a result. But what if the term generates an unequivocal net loss for the class of buyers taken as a single group, but not every consumer loses? In this case, we can say that regulation that prices the whole group out of the market generates a net benefit. But it does so at the expense of the sub-class who would have ended up paying a very low interest rate, never getting in any trouble with payments, and never presenting a desirable target for unscrupulous servicers looking to appropriate borrower equity. This borrower made the right choice in eschewing protective compulsory terms in exchange for a lower interest rate, and the advent of regulation will deprive him of the chance to succeed.

At this point, some quite complex policy questions arise. (a) We may regard the consumers who gain as more virtuous than those who lose, and feel that it is unfair to protect the relatively faulty at their expense. Of course, this argument is subject to the situationist critique above. If we decide to permit the unsafe agreement in spite of the net loss it produces, rather than regulating the contract protectively, we will have made an implicit interpersonal comparison

of utilities, valuing the gains to the minority over the losses to the majority. (Remember that in this hypo, the market is competitive, with marginal cost pricing, so that there is no issue of super-competitive profits for lenders.)

In the course of the debates about residential mortgage terms, it sometimes appears that opponents of regulation believe that there are external social benefits from the success of the minority in this kind of contract, at least in the case of first time homebuyers. They become homeowners rather than renters, start building equity, and have incentives for home improvement and neighborhood involvement that will benefit their neighbors as well as themselves.

The losses to consumers who take out mortgages but eventually end up losing their homes and equity are understood as a kind of cross-subsidy, part of the price paid for the successful to succeed. In this view, permitting dangerous terms should increase the homeownership rate, generating net overall social benefit, in spite of net losses to the class taken as a whole. Without belaboring the point, the current crisis, in which very few recent first time homebuyers are winners, with major negative neighborhood effects, illustrates the potential down side of the anti-paternalist de-regulatory strategy.

The choice of a solution in this situation will almost certainly be made on the basis of quite limited data, and the complex political or ideological preferences of the decision maker will obviously weigh heavily. This is a remark that will have to be repeated periodically throughout the analysis of the other issues presented.

Next section:

B. Regulation as a tool against above marginal cost pricing through price discrimination