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FOREWORD

CONSUMER FINANCIAL SERVICES LAW AND POLICY: 1968–20?? IN THE THICK OF THE BATTLEFIELD FOR AMERICA’S ECONOMIC SOUL

Kathleen E. Keest*

An adversarial model of the law is in essence a contest of competing narratives. Each side musters its evidence and arguments to tell a story, and tries to undermine the opponent’s story. They lay the matter before a judge or jury, and we, as a society, trust that truth and justice emerge from that process, at least often enough for the system to sustain the faith of the citizenry in its integrity and capacity to deliver on that promise.

The legislative and common law norms that courts are to enforce emerge from competing narratives, as well. Public policies emerge from all the large and small choices that our public and private institutions make—through action or inaction—from among the predictive and prescriptive stories proffered by proponents on all sides.

History is no less a battle of competing narratives. This issue of the Georgia State University Law Review, with its focus on consumer financial services law and policy, comes at a time when once again we are at a crossroads in our political economy. The financial crisis that started in 2007 convinced most people that something went profoundly wrong. But what? And what to do about it? History, of

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The CRL is a non-partisan, non-profit research and policy organization, affiliated with the Center for Self-Help, a non-profit community development institution based in Durham, North Carolina, which has provided over \$5 billion of financing to low-wealth families, small businesses, and non-profit organizations in North Carolina and around the country. Prior to her work at CRL, she was an Assistant Attorney General and Deputy Credit Code Administrator in the Iowa Attorney General’s office, and an attorney specializing in credit regulation at the National Consumer Law Center. She began her career as a Legal Services attorney in Iowa.

course, is always the ultimate arbiter of such questions, but it takes a while for its verdict to come into clear focus. In the meantime, we write the stories that we hope will influence history's judgment.

* * *

Over the past thirty to forty-odd years, consumer financial services policy has been one of the fields on which the competition for the dominant economic policy narrative in the larger society has been played. What economic principles should provide the framework for our policies regarding the interaction between financial businesses and their customers? To what extent should government set the rules of the game? Who (or what) should serve as the referee on the playing fields for the games between business and consumers?

Where you stand on those questions is probably correlated with where you stand on the next questions. Does the market automatically self-correct, or can it perversely create incentives for conduct that imposes serious external costs on society? Do consumer protection laws and regulations increase costs to consumers, reduce the availability of credit, and stifle innovation, as the "light-touch" and hands-off narrative goes? Or is public regulation necessary to avoid market cheating, or exploitation of the less sophisticated party in transactions between the professionals in the business and any given consumer? Might it even be necessary to avoid a race to the bottom where irresponsible, unfair and deceptive practices are rewarded (at least in the near term) to the ultimate detriment of consumers and fair competition, and even the economy as a whole, as another story goes?

At the beginning of this period, 1968, the prevailing narrative was that of a competitive market, but one that operated within the bounds of substantive legal ground rules. The ground rules included, for example, usury ceilings and other outside limits on terms and practices. This approach to consumer financial services had been the

norm throughout most of the Twentieth century.¹ Regulation was decided at the state level, as consumer protection historically was considered a matter of state concern. During the decade between 1968 and 1978, it began to be a federal concern, as well. Congress added most of the chapters in the federal consumer protection act during that decade.²

But the country experienced serious inflation in the late-1970s to early-1980s, and the Federal Reserve Board's monetary policy to combat it sent interest rates to historic highs. Those interest rates butted up against mortgage rate ceilings, and the housing and mortgage industry sought legislative relief. Most states responded by lifting mortgage rate caps entirely, or by enacting floating rate ceilings. (Floating ceilings put a cap at a specified margin above a specified market-based index, to assure that the cap will not be below market rates.) Congress followed, deregulating mortgage lending by preempting state laws limiting interest rates, points, and non-standard terms such as adjustable rates, balloon payments, and negative amortization.³

1. For an excellent overview of the early Twentieth century reform efforts on small loan lending, see generally *Combating the Shark*, Symposium, 8 LAW & CONTEMP. PROB. 1-205 (Winter 1941). (It is especially interesting in light of the current debate over payday lending. This business model is strikingly similar to one used at the turn of the Twentieth century that was the object of that early reform movement.) A good general history of the development of consumer financial services regulation up to the late 1960s is BARBARA CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION (Univ. of Chicago Press 1966).

2. Most of the titles that compose the federal Consumer Credit Protection chapter in the U.S. Code were enacted between 1968 and 1978. Subch. I, Truth in Lending Act (TILA), 15 U.S.C. § 1601 *et seq.* (1968), including the Fair Credit Billing Act, 15 U.S.C. § 1666 (1974) and Consumer Lease Act, 15 U.S.C. § 1667 (1976); Subch. II, Restrictions on Garnishment, 15 U.S.C. § 1671 (1968); Subch. III, Fair Credit Reporting Act, 15 U.S.C. § 1681 (1970); Subch. IV, Equal Credit Opportunity Act, 15 U.S.C. § 1691 (1974); Subchapter V, Fair Debt Collection Practices Act, 15 U.S.C. § 1692 (1977); Subchapter VI, Electronic Funds Transfer Act, 15 U.S.C. § 1693 (1978). The federal financial regulators were given authority to define unfair and deceptive acts and practices for financial institutions by regulation in 1975. 15 U.S.C. § 45(a)(2) (2006).

3. The Depository Institutions Deregulation and Monetary Control Act (DIDA) preempted state interest rate and points caps on first lien mortgages in 1980. 12 U.S.C. § 1735f-7a (1980). The Alternative Mortgage Transactions Parity Act (AMTPA) preempted state laws limiting non-traditional mortgage terms in 1982. 12 U.S.C. § 3801 *et seq.* (1982). There were no substantive federal substitutes for the preempted state law, thus effectively deregulating the mortgage market. See generally ELIZABETH RENUART, KATHLEEN E. KEEST, ET AL., THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES, §§ 3.10-3.11 (4th ed. 2009). For a history of this period, including the state law responses to the record-high interest rates, see Cathy Lesser Mansfield, *The Road to Subprime "HEL"*

Deregulation as to substantive terms, then, began as a practical solution to temporary market conditions. But it stayed in the public policy debate as the more dominant narrative over the following thirty years as a matter of philosophy. Then, once again, the larger economy experienced a seismic shock. In 2007–2008, our financial system came close to collapse, triggering an international economic crisis and the Great Recession.

In a hundred years, history may judge this most recent financial market meltdown as the end of an era, the beginning of the end of an era, or just as a bump in the road. Congress is currently considering what, if anything, to do to prevent a recurrence,⁴ as is the rest of the world. We don't have a winner yet in the battle of competing narratives over the causes and implications of the crisis, but the debate is in process, and it is making for a very noisy and smoky battlefield in Washington—so noisy and smoky that it's still hard to see clearly now. “It was ‘short-termism’ and greed by the financial sector, forsaking sound business practices in pursuit of short term profits and growth.” “It was the government's fault: too much intervention and mis-directed policies.” “It was government doing too little to curb reckless, irresponsible, and abusive behavior in the market.” “It was the borrowers' fault: they bought more house than they could afford.” “It was everybody's failure to come to grips with the increasing financial insecurity of American households.” “It was the Greenspan Fed's monetary policy of keeping interest rates too low too long.” “It was a global glut of money, looking for higher returns and finding it in mortgage-backed securities based on houses on cul-de-sacs in the sunnier parts of America.” “It was all of the above and more.”

While Congress is debating specific reform proposals, the Financial Crisis Inquiry Commission (FCIC), established in 2009 to “examine the causes, domestic and global, of the current financial

Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C. L. REV. 473 (2000).

4. The House of Representatives passed a financial reform package in December 2009. The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009). The Senate Banking Committee is in negotiations as this is being written.

and economic crisis in the United States,”⁵ just held its first hearing at the time of this writing.⁶ The FCIC is charged with examining some twenty-two “areas of inquiry related to the financial crisis,” including:

- fraud and abuse in the financial sector, including fraud and abuse towards consumers in the mortgage sector;
- Federal and State financial regulators, including the extent to which they enforced, or failed to enforce statutory, regulatory, or supervisory requirements;
- the global imbalance of savings, international capital flows, and fiscal imbalances of various governments;
- monetary policy and the availability and terms of credit;
- accounting practices, including, mark-to-market and fair value rules, and treatment of off-balance sheet vehicles;
- tax treatment of financial products and investments;
- capital requirements and regulations on leverage and liquidity, including the capital structures of regulated and non-regulated financial entities;
- credit rating agencies in the financial system, including, reliance on credit ratings by financial institutions and Federal financial regulators, the use of credit ratings in financial regulation, and the use of credit ratings in the securitization markets;
- lending practices and securitization, including the originate-to-distribute model for extending credit and transferring risk;
- affiliations between insured depository institutions and securities, insurance, and other types of nonbanking companies;

5. Fraud Enforcement and Recovery Act of 2009 § 5(a), Pub. L. No. 111-21, 123 Stat. 1617 (2009).

6. The FCIC held its first public hearing on January 13, 2010. <http://www.fcic.gov/hearings/01-13-2010.php>. The FCIC website explains that “[i]n the wake of the most significant financial crisis since the Great Depression, the President signed into law on May 20, 2009, the Fraud Enforcement and Recovery Act of 2009, creating the Financial Crisis Inquiry Commission.” <http://www.fcic.gov/about>.

- the concept that certain institutions are 'too-big-to-fail' and its impact on market expectations;
- corporate governance, including the impact of company conversions from partnerships to corporations;
- compensation structures;
- changes in compensation for employees of financial companies, as compared to compensation for others with similar skill sets in the labor market;
- the legal and regulatory structure of the United States housing market;
- derivatives and unregulated financial products and practices, including credit default swaps;
- short-selling;
- financial institution reliance on numerical models, including risk models and credit ratings;
- the legal and regulatory structure governing financial institutions, including the extent to which the structure creates the opportunity for financial institutions to engage in regulatory arbitrage;
- the legal and regulatory structure governing investor and mortgagor protection;
- financial institutions and government-sponsored enterprises; and
- the quality of due diligence undertaken by financial institutions.⁷

It is possible that there will be few acquittals from this list of possible culprits, and more may be added to the list before all is said and done. Probably most of them were contributors in varying degrees, and undoubtedly they interacted in a way that amplified negative consequences far beyond the damage each of them would have wrought standing alone.

But how did we manage to create so many storm cells at roughly the same time—cells that would merge into this Perfect Storm? The current Chair of the Federal Deposit Insurance Corporation, Sheila

7. Fraud Enforcement and Recovery Act of 2009 § 5(c)(1)(A)–(V).

Bair (and one of the few early warning voices in official Washington) testified at the first FCIC hearing that

[t]his crisis represents the culmination of a decades-long process by which our national policies have distorted economic activity away from savings and toward consumption, away from investment in our industrial base and public infrastructure and toward housing, away from the real sectors of our economy and toward the financial sector. No single policy is responsible for these distortions, and no one reform can restore balance to our economy.⁸

That is a fair assessment, but it still leaves questions of which policies? How and why did those distortions become the norm, and why did they have such lasting power?

It may help to view these questions against the larger canvas of trends in the culture at the same time—in our economic academy, our corporate culture, the law, and in politics over roughly the same time span. All of these trends converged into a shift in the *zeitgeist* that led to a reversal of the dominant narrative—the transformation of the market into “The Market”—a cultural, political, and even legal force of its own.

* * *

As we listen to broadcast news and commentary, we almost can hear the capital letters—“The Market” as a proper noun, and anthropomorphized. “The Market” was pleased by this event “The Market” was displeased by that speech “The Market” was jittery after something did or did not happen. Indeed, some commentators have been struck by the almost theological overtones

8. *The Causes and Current State of the Financial Crisis Before the Fin. Crisis Inquiry Comm'n* (Jan. 14, 2010) (Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation), available at <http://www.fcic.gov/hearings/pdfs/2010-0114-Bair.pdf>.

to our cultural embrace of “The Market”—“omnipotent, . . . omniscient . . . and omnipresent.”⁹

That transformation may have begun in the halls of the academy where our economists and our MBAs are trained. In economics departments, the “efficient markets” or *laissez-faire* school became the dominant orthodoxy over the past four decades. Under this school of economic thought, markets are self-correcting, hence best left alone. Agents in the market (that would be the people involved) are rational actors.¹⁰ The standard methodology became mathematical modeling, rather than real world study of human and institutional behavior. The assumptions plugged into those mathematical models, in turn, were predicated upon those efficient market axioms.

There was a corollary in our business schools, as the premise that the sole responsibility of a corporation is to maximize profits for its shareholders came to carry the day.¹¹ “The Market” migrated into the law, as well, with the rise of the Law and Economics school, which includes influential appellate judges like Judge Richard Posner among its proponents.

Arguably the election of Ronald Reagan in 1980 represented not just the political embrace of faith in the “The Market” by a winning candidate, but its embrace as a fundamental value of the culture. This is part of the reason he is perceived as a transformational president,

9. Harvey Cox, Notes & Comments, *The Market as God: Living in the New Dispensation*, ATLANTIC MONTHLY, Mar. 1999, at 19. E.g. THOMAS FRANK, ONE MARKET UNDER GOD: EXTREME CAPITALISM, MARKET POPULISM, AND THE END OF ECONOMIC DEMOCRACY (Doubleday 2000).

10. My own perspective is that this fundamental axiom assumes away reality, since human history is full of human irrationality. And however rigorous the steps that follow may be, that assuming away reality part is bound to come back and bite. One of my favorite examples of the fallacy in play: After I talked about widespread flawed underwriting and appraisals in the non-prime mortgage market at a meeting in early 2005, a fellow panelist who was an official at a nonprime lender could not contain himself: “It doesn’t happen. This is a business, and that would be stupid business.” Obviously, I must have been mistaken that The Market might such stupidity to infect itself. (Today, however, widespread reckless underwriting is almost universally conceded to be a cause of the mortgage meltdown. See, e.g. Structured Finance in Focus, A Short Guide to Subprime, *The Subprime Decline—Putting it in Context*, Moody’s Investors Service, March 2008 (“The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market.”) (available at <http://www.sec.gov/comments/s7-13-08/s71308-58.pdf>).

11. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, NEW YORK TIMES MAGAZINE at 17 (September 13, 1970), available at <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html> (last visited March 6, 2010).

irrespective of one's views on whether it was for better or worse. Its political message—trust the private sector *instead* of government, rather than valuing both, and trying to design business and political processes aimed at assuring that both sectors warrant the public trust. Over the past thirty years it seems as if economics was politicized, while politics and public policy were “Marketized.”

But, of course, there have been competing narratives on all these fronts throughout this era. And today, in light of the crisis, they are being heard more. Behavioral economists are making rapid progress at getting their perspective into the mainstream of academia and the policy world.¹² The general press has begun to bring them into the national conversation, as well.¹³ (At the risk of oversimplifying, behavioral economists believe that people—on both sides of a transaction—aren't always rational. Radical, I know, but there it is.) In the business world, we are beginning to hear more that corporate responsibility is to both shareholders and stakeholders, and not measured simply by next quarter's profit and loss statements. Recently the CEO of PepsiCo attributed the financial meltdown to a “maniacal focus on the shareholders.”¹⁴ Her suggested cure for business: “our new P & L actually says revenue, less costs of good sold, less costs to society—and that's your real profit.”¹⁵ Even some

12. See, e.g. Michael S. Barr, Sendhil Mullainathan, & Eldon Shafir, *Behaviorally Informed Financial Services Regulation*, Oct. 2008, http://www.newamerica.net/files/naf_behavioral_v5.pdf. Mr. Barr was subsequently appointed to be Assistant Secretary of the Treasury for Financial Institutions. See also RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (Yale Univ. Press 2008). Mr. Sunstein was appointed by President Obama to the White House Office of Information and Regulatory Affairs.

Controversial, but almost universal, credit card practices that Congress recently took aim at with the Credit Card Accountability, Responsibility and Disclosure (CARD) Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734, cannot be explained by efficient market theory (except as a massive “market failure”), but are well explained under other economic analytical frames. See Joshua M. Frank, *What Does the Credit Card Market Have In Common with a Peacock?*, LYDIAN PAYMENTS J., Nov. 2009, at 24–40, available at <http://pymnts.com/assets/Shared/LPJ-Vol1-No1.pdf>.

13. E.g. Dan Ariely, author of *PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS* (HarperCollins 2008) and a behavioral economist is frequently seen and heard in the popular business press.

14. *PepsiCo CEO: Refine Profit and Loss*, NPR Marketplace, Jan. 29, 2010, <http://marketplace.publicradio.org/display/web/2010/01/29/pm-davos-pepsi-ceo-q/>.

15. *Id.* See generally, MARJORIE KELLY, *THE DIVINE RIGHT OF CAPITAL: DETHRONING THE CORPORATE ARISTOCRACY* (Berrett Koehler 2001).

of those within the industry are expressing second thoughts,¹⁶ as has the most famous “light-touch” federal regulator. Former Federal Reserve Board Chairman Alan Greenspan admitted to a House panel looking at the role of federal regulators in the crisis that he was shocked to find “a flaw in the model that defines how the world works”¹⁷—in other words, the world view behind his regulatory laissez-faire philosophy. On the Law and Economics front, Judge Richard Posner, one of its foremost proponents has revisited some of his core economic assumptions, as well.¹⁸

We’ve seen that deceptive or unfair practices can be good for market share and share value in the short term, so the competitive pressures can mean a race to the bottom, if there is no regulatory floor.¹⁹ Citibank, for example, tried to voluntarily abandon the controversial universal default practice in its credit card business, but reversed itself when revenues declined, and no one else followed.²⁰ So, in the wake of the crisis, the concept of regulation as a safety net

16. John Robbins, former chair of the Mortgage Bankers Association, said: “We forgot about our customers, and making money and our commission checks were more important.” Kate Berry, *Wachovia Alum has Tips for an Industry Rebound*, AM. BANKER, Sept. 15, 2008, available at http://www.americanbanker.com/issues/173_183/-361981-1.html.

17. His testimony on this and other aspects of his consumer protection philosophy while Chair of the Federal Reserve Board (FRB) is quoted in Testimony of Prof. Patricia McCoy, *Consumer Protections in Financial Services: Past Problems, Future Solutions Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 17–18 (2009), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=11be680d-04db-42cc-89bf-7fe4ffe4d9cd&Witness_ID=b6ba604a-d441-43e3-9951-1fbab4b11e57. See also Paul Krugman, *How Did Economists Get It So Wrong?* NEW YORK TIMES MAGAZINE, Sept. 6, 2009, at 36.

18. RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* xii (Harvard Univ. Press 2009) (“We are learning from it that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience—the self-healing powers—of laissez-faire capitalism.”).

19. Compare the 1935 observation of Frank Hyneman Knight in *THE ETHICS OF COMPETITION* 42 (Transaction Publishers 1997) (“[T]here is truth in the allegation that unregulated competition places a premium on deceit and corruption.”) with the admission of FRB Chairman Bernanke of the role they contributed to the recent crisis. See Statement of Chairman Ben Bernanke, FRB Press Release, July 14, 2008, <http://www.federalreserve.gov/newsevents/press/bcreg/bernankereg20080714.htm>. (unfair and deceptive practices by lenders resulted in loans that were “inappropriate for or misled the borrower.”)

20. See, e.g. Elizabeth Warren, Opinion: *Wall Street's Race to the Bottom*, WALL ST. J., Feb. 8, 2010, at A19. Universal default allowed credit card issuers to raise interest rates on their card holders existing balances to penalty rates that were often double what the rate was when the debt was incurred—without the consumer ever having breached his contract with the issuer. The extra interest was very profitable.

is coming back. Whether the current debates mean another paradigm shift of the magnitude of the one at the front edge of this era is yet to be seen. But it is in play.

* * *

As it happens, the professional careers of most of the authors represented in this series also span most or all of this same period, and consumer financial services law has been their area of specialization. They have not been mere academic observers, either. Most have contributed to the development of the field. They, too, have stories that help illustrate consumer financial services law as part of the battleground over the economic soul of the country over the past generation. Professor Budnitz chronicles the growth of what was a rarity in the field we began our careers—consumer financial services lawyers who represented actual consumers, and brought their clients’ stories into the record and into these policy debates. Professors Alces and Greenfield’s article revives some basic principles of contract law that have often seemed hard to get traction in a Law and Economics environment. Professors Miller and Harrell weigh in directly with their views as to some of the current policy debates arising out the crisis, adding their narratives to the many already out there, and many more yet to come.²¹

But the last chapter on this debate at the intersection of politics, policy, law, and economics has yet to be written. So tune in again later—to see what the coming of age story of consumer financial services looks like from perspective of history.

21. In the interest of full disclosure, my colleagues and I at the CRL are among those who have offered explanations as to what did, and did not, contribute to the crisis. See, e.g., *Testimony of Julia Gordon Before the Fin. Crisis Inquiry Comm’n* (Jan. 13, 2010), available at <http://www.fcic.gov/hearings/pdfs/2010-0113-Gordon.pdf>; *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis Before the S. Comm. on Banking, Housing and Urban Affairs* (2008) (Statement of Eric Stein, Senior Vice President, CRL); Kathleen E. Keest, *The Subprime Housing Crisis Symposium: The Way Ahead: A Framework for Policy Responses*, Dec. 9, 2008, <http://www.responsiblelending.org/mortgage-lending/policy-legislation/The-Way-Ahead-A-Framework-for-Policy-Responses.html>; Testimony of Prof. Patricia McCoy, *supra* note 17, at 17–18.

