Introducing “Abusive”: A New and Improved Standard for Consumer Protection

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The economic downturn of 2008 made the American consumer a focus of intense curiosity and concern. Responding to this concern, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, introducing a new standard for consumer financial protection: “abusive.” This standard is distinct from existing standards because it recognizes the imbalance between consumers and lenders in terms of understanding contract terms, obtaining information, altering the terms of an agreement, and evaluating and bearing risk. In doing so, it pushes back against narratives that lay the blame for the financial collapse at the feet of consumers without taking into account the structure of the consumer financial products market.

Over eighty years after their introduction in consumer financial protection legislation, the terms “deceptive” and “unfair” no longer define the limits of consumer protection. Now, both advocates and policy makers must begin the long, collaborative endeavor of shaping what lies beyond those bounds. Reading the text of Dodd-Frank against its legislative history and social context suggests three ways the new “abusive” standard can be used. First, it can make consumer choices more meaningful by enhancing consumer understanding of contractual language—either directly or by motivating lenders to better inform their customers. Second, the “abusive” standard can give the Consumer Financial Protection Bureau power to modify products and take the most dangerous ones off the market entirely. Finally, the standard can impose a greater obligation on lenders to

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act in the interests of consumers. Exploring these avenues for implementation is the first step in developing a new framework for consumer financial protection.

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Like many Americans in 2008, Diane McLeod was deeply in debt. She owed $237,000 on her home, which was in foreclosure, and another $34,000 in credit card debt. Her story illustrates some of the forces—unemployment, illness, and lack of financial expertise—that have led many down a similar path.

In 2003, when Ms. McLeod bought her home, the bank did not require that she make a deposit on her $135,000 mortgage. When she consolidated her credit card debt into this loan a year later, the bank once again did not require that she put any money down. Instead, she was charged an $8000 prepayment penalty. She paid this penalty using her retirement account, incurring another penalty of $3000, which she then put on her credit card. Struggling with growing credit card debt, she refinanced, taking out a $165,000 loan. Precarious though her situation was, she was able to get by until 2005 when the department store where she worked cut back her hours. Then, in 2006, she found out that she needed a hysterectomy, and in 2007 she suffered a ruptured appendix. During this time, her credit card debt continued to grow. She borrowed both to cover the cost of her prescription drugs and to shop as a way of “dealing with [her] emotions.” By that fall, she had to stop paying her credit card bill in order to stay current on her mortgage, which she could no longer afford a year later. Finally, in early 2008, she lost her part-time job at Verizon; by that summer, she expected she would have to declare bankruptcy.

It is easy to focus on Ms. McLeod’s actions and the mistakes she made. Yet such a focus elides the key role of lenders who profited handsomely from her slide into financial ruin. In 2007, she earned $48,000 before taxes and was
charged $20,000 in interest. The companies to which she owed the most money—Capital One, GE Money Bank, and CitiFinancial—had seen their profits rise continuously since the early 2000s. These lenders did not limit Ms. McLeod’s access to credit as her debt rose and her home equity dwindled. Even in the spring of 2008 she was still receiving offers for new credit cards. Until the fall of 2007 she was, in fact, a “dream customer for lenders” because of how much she paid each month in interest and fees. That is why we cannot simply shake our finger at Ms. McLeod, but must instead consider whether her behavior was really so unexpected given the seemingly endless flow of credit offered to her. Further, we should consider how changing the rules of the consumer finance marketplace might help prevent people like her from taking on unmanageable debt.

Congress introduced the possibility of a safer marketplace when it created a new legal standard to protect consumers buying financial products. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) not only created the Consumer Financial Protection Bureau (CFPB) but also gave it rulemaking and enforcement authority to prevent “unfair, deceptive, or abusive act[s] or practice[s] under federal law in connection with any transaction with a consumer for a consumer financial product or service.” While the standards “unfair” and “deceptive” have been in use since the Federal Trade Commission Act was passed in 1914, the “abusive” standard is new and suggests innovative ways of thinking about interactions between consumers and lenders.

12. Id.
13. Id.
14. Id.
15. Id.
20. See, e.g., SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS 1, 179 (2010), available at http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf (“Although ‘unfair’ and ‘deceptive’ acts or practices have been prohibited for some time under Section 5 of the Federal Trade Commission Act and similar state laws, the prohibition of ‘abusive’ acts or practices is new.”); Linda Singer et al., Breaking Down Financial Reform: A Summary of the Major Consumer Protection Portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 14 J. CONSUMER & CON. L. 2, 4 (2010) (“The Act also adds to existing prohibitions on unfair and deceptive acts and practices, a bar on ‘abusive’ practices. It is unclear precisely what this third prong will add, though it seems to both permit and encourage regulators to focus on the victims of financial fraud—allowing
Section 1031(d) of Dodd-Frank defines an abusive practice as one that “materially interferes” with the consumer’s ability to understand a term or condition of a financial product, or takes “unreasonable advantage” of the consumer’s lack of understanding, inability to protect his or her interests, or reasonable reliance on the lender.\(^{21}\)

As a textual initial matter, abusive means something distinct from both deceptive and unfair. These two terms have a long history under the Federal Trade Commission (FTC) Act. “Deception” requires an affirmative act to mislead a consumer while “unfairness” imposes a reasonability requirement on consumers and only punishes harmful conduct that outweighs “countervailing benefits to consumers or to competition.”\(^ {22}\) The plain language of these statutes does not require those applying them to consider systematic ways in which consumers may be differently situated than businesses and less equipped to bear risk.

By contrast, the definition of abusive explicitly recognizes the imbalance between consumers and lenders in terms of understanding and access to information, placing responsibility on lenders who take advantage of this imbalance.\(^ {23}\) The plain language, however, goes only so far in explaining how this new standard can change the existing regulatory approach. Where the plain language is indeterminate, legislative history and the statute’s stated policy are relevant to determine the range of permissible interpretations available to the CFPB.\(^ {24}\)

There are many permissible ways to implement this new “abusive” standard and many questions that regulators will need to answer. For example, what level of harm will be sufficient to merit enforcement action? Must lenders assess “lack of understanding” on an individualized basis prior to entering into each contract, or is it to be measured on a group level, perhaps by regulators conducting surveys at regular intervals? Can sophisticated consumers waive the protections of this statute? Will this standard be more effective as an ex ante tool for regulation or an ex post tool for litigation? Although this Comment cannot definitively answer these questions, the following analysis of the action against practices that target specific groups, such as the elderly and non-English speakers, for example, who are particularly vulnerable to financial scams.”); Jeff Sovern, The Obama Administration’s Consumer Financial Protection Agency Bill and Abusive Practices, PUB. CITIZEN CONSUMER LAW & POLICY BLOG (July 20, 2009), http://pubcit.typepad.com/clpblog/2009/07/the-obamas-administration-consumer-financial-protection-agency-bill-and-abusive-practices.html (“The phrase ‘unfair and deceptive’ has a long history in litigation under the Federal Trade Commission Act . . . . So those phrases seem relatively well understood. But what are abusive practices?”).

23. The Act prohibits taking “unreasonable advantage of a lack of understanding” or an “inability” to protect one’s own interests. 12 U.S.C. § 5531(d)(2).
legislative history, existing regulatory scheme, and possibilities for implementation offers a framework in which to approach them.

Understanding the meaning of abusive requires acknowledging that it was designed in the midst of a national conversation about the operation of contract law in an area—consumer finance—where many people neither fully read nor fully comprehend the details of the contracts they sign. Given their length and linguistic intricacy, many find it rational to sign consumer contracts without reading them fully because the information gained from additional reading would not outweigh the value of the time invested. This is particularly true where the customer has little ability to negotiate unappealing terms. While sophisticated consumers may increase demand for better products, less sophisticated customers will continue to form a separate market for risky products, perpetuating a system of parallel markets subject to separate forces.

The fact that many consumers rationally elect not to fully read many of the contracts they sign undermines arguments that consumer contracts should be strictly enforced as expressions of the parties’ intentions. Allowing lenders to hide less favorable terms in the fine print has led to the proliferation of dangerous products tailored to appeal to consumers’ misperceptions. As the market continues to reward lenders who charge high interest rates and penalty fees, those lenders continue to target the consumers they expect are most likely to default and pay high fees: those in financially precarious positions.

The “abusive” standard is poised to correct these market defects in three ways. First, it can make consumer choices more meaningful by ensuring more

25. See, e.g., DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 1, 67 (2009) available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf [hereinafter “TREASURY DEPARTMENT WHITEPAPER”] (“In the credit card market, the opacity of increasingly complicated products led major card issuers to migrate almost uniformly to unfavorable methods for assessing fees and interest that could easily trap a responsible consumer in debt. Competition did not force these methods out, because consumers were not aware of them or could not understand them.”) (emphasis added).


27. Eisenberg, supra note 26, at 216.


30. Although it leaves intact arguments that such contracts should be strictly enforced as a means of respecting the parties’ autonomy or for reasons of economic efficiency.

31. See Korobkin, supra note 26, at 1234–43.

32. Morgenson, supra note 1 (“Lenders have been eager to expand their reach. They have honed sophisticated marketing tactics, gathering personal financial data to tailor their pitches. They have spent hundreds of millions of dollars on advertising campaigns that make debt sound desirable and risk-free. The ads are aimed at people who urgently need loans to pay for health care and other necessities.”).
consumers understand the contracts they sign. Regulators can approach this high-level goal by educating consumers, requiring lenders to assess consumers’ financial sophistication prior to contracting, requiring lenders to flag key risks up front, or requiring that lenders revise their contracts to make them shorter, less jargon heavy, and cognitively easier to process.33 Since they all have tradeoffs, it is likely that the CFPB will use these tools in combination. Regulating contract design and other disclosure mechanisms can provide a back door into regulating product design—the push toward “simpler” contracts could effectively force lenders to offer products with fewer hidden features or fewer points of departure from competitors’ products.34 The CFPB should assess the impact that disclosure requirements may have on product design, as well as the depth and nature of consumer interest in diverse product offerings. The guiding principle is that if consumers demonstrably understood the terms of their contracts, their consent would be a better indicator of their actual preferences.

Second, the “abusive” standard gives the CFPB some power to regulate products directly and take the most “dangerous” products off the market. “Dangerous” products are those that cannot be used in a safe manner because they are inherently too expensive for the audience to which they are marketed and thus systematically decrease the welfare of vulnerable members of society.35

Third, the “abusive” standard allows the CFPB to impose an explicit obligation on lenders to act in consumers’ interests. However, the political feasibility of exercising the full extent of this authority remains to be seen.

Part I maps out the existing regulatory backdrop against which the “abusive” standard emerges as a unique and potentially powerful tool. Part II narrates the legislative history of the “abusive” standard. Part III describes the problems that existing legal standards have failed to prevent or repair. Part IV introduces several possible applications of the “abusive” standard, offering some initial landmarks in the broad and unexplored territory beyond “unfairness” and “deception.”

33. The Consumer Financial Protection Bureau (CFPB) has started work in this area by designing a new mortgage disclosure form. Currently, there are two disclosure forms required by federal law, one under the Truth in Lending Act and one under the Real Estate Settlement Procedures Act. Section 5532(d) of Dodd-Frank commanded the agency to combine these forms and make them available for public comment within a year of the transfer date. Although the redesigned form offers a glimpse of the CFPB’s drafting style, this task is relatively discrete and well defined compared to its authority to regulate under the “abusive” standard. The two proposed forms were tested in Philadelphia, Pennsylvania, in January 2012. Know Before You Owe, CONSUMER FIN. PROT. BUREAU, http://www.consumerfinance.gov/knowbeforeyouowe/ (last visited June 9, 2012).


I.
THE OLD GUARD: EXISTING CONSUMER PROTECTION STANDARDS DID NOT PREVENT THE FINANCIAL CRISIS AND CANNOT RESTORE THE MARKET IN ITS WAKE

Understanding the need for a new legal standard requires a review of the existing consumer protection mechanisms that govern consumer financial products. The three most important standards are “deception” and “unfairness” as defined in the FTC Act36 and the common law doctrine of unconscionability. In addition, certain statutes impose specific procedural—and occasionally substantive—requirements on consumer lenders.37 These standards and rules, though vitally important to ensuring a fair marketplace, were not specifically designed to address structural imbalances in the consumer financial products market. Limited by older theories of consumer behavior, past political battles, and inflexible jurisprudence, these standards did not prevent and cannot remedy the abuses that contributed to the recent economic collapse.

A. The Current Disclosure Regime Cannot Fix the Consumer Finance Market

Disclosure is governed largely by one of the paradigmatic consumer financial protection statutes, the Truth in Lending Act (TILA).38 Passed in 1968, TILA’s declaration of purpose—to “assure a meaningful disclosure of credit terms” so “consumers will be able to compare” products more readily—resonates in today’s economy.39 TILA’s solution to the problem of uninformed, underinformed, and misinformed consumers is to require that consumer financial providers disclose a myriad of specific pieces of information to consumers obtaining credit.

However, TILA has little to say about how that information should be organized and conveyed. For example, solicitations for credit cards must include the minimum interest charge, annual percentage rate (APR), variable rate information, discounted initial rate, premium initial rate, penalty rates, introductory rate, rates dependent on consumer creditworthiness, fixed finance charges, transaction charges, grace period, balance computation method, late fees, cash advance fees, over-the-limit fees, balance transfer fees, returned payment fees, required insurance, available credit, and a website reference.40 However, only a few TILA provisions deal with the style or presentation of this information. While TILA requires that certain terms be displayed more conspicuously than others or in a tabular format,41 prescribes certain mandatory

38. Id.
39. Id. § 1601.
40. Credit and Charge Card Applications and Solicitations, 12 C.F.R. § 226.5a(b) (2012).
41. Id. § 226.5(a)(3).
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warnings, and seeks to impose consistency in the way that key figures (like APR) are calculated, its real focus is on inclusion and comprehensiveness. Thus, TILA does not require a regulator to determine whether a disclosure actually does inform consumers.

Likewise, the Home Ownership and Equity Protection Act of 1994 (HOEPA), passed as an amendment to TILA, relies heavily on the tool of disclosure to regulate the most expensive mortgages. Although the scope of HOEPA is fairly narrow, it does prohibit some of the most damaging practices that led to the subprime crisis, including balloon payments, interest rates that increase after default, negative amortization, most prepayment penalties, and some due-on-demand clauses. In addition, lenders must provide disclosures indicating the APR, monthly payment amount, and maximum possible monthly payment under a variable rate loan, as well as the fact that borrowers need not complete the transaction and could lose their home if they default on the mortgage loan. However, HOEPA contains no provisions requiring a lender to explain any of the terms or verify the borrower’s understanding.

Thus, TILA and HOEPA have not succeeded in “assuring a meaningful disclosure of credit terms” so that consumers can “compare” and “avoid the uninformed use of credit.” Instead, customers continue to suffer from thorny and impenetrable contracts.

B. The Deceptiveness Standard Enforces Only the Disclosure Regime

According to the chairman of the FTC, an act or practice is “deceptive” if it is likely to mislead consumers acting reasonably under the circumstances, thereby causing material harm. Although this definition was not codified in

42. “A written statement in the following form: ‘Minimum Payment Warning: Making only the minimum payment will increase the amount of interest you pay and the time it takes to repay your balance,’ or such similar statement as is established by the Board pursuant to consumer testing,” 15 U.S.C. § 1637(b)(11)(A).
45. HOEPA applies only to first mortgages whose annual percentage rates (APRs) exceed the Treasury rate by 8 percent, second mortgages whose APRs exceed the Treasury rate by 10 percent, and any mortgage in which the consumer pays more than the greater of 8 percent of the principal or $583 (adjusted annually for inflation) in up-front points and fees. 12 C.F.R. § 226.32(a).
46. Due-on-demand clauses are permissible if “(i) [t]he consumer fails to meet the repayment terms of the agreement for any outstanding balance; or (ii) [t]he consumer fails to meet the repayment terms of the agreement for any outstanding balance; or (iii) [t]here is any action or inaction by the consumer that adversely affects the creditor's security for the loan, or any right of the creditor in such security.” Id. § 226.32(d)(8).
47. 15 U.S.C. § 1639(a), (b).
48. Id. § 1601(a).
either the FTC Act or Dodd-Frank, J. Howard Beales, a former director of the FTC’s Bureau of Consumer Protection, explains that “deception” is best thought of as a subset of “unfairness,” since the practice of lying to consumers is likely to cause substantial injury that they cannot avoid without accurate information about risk. This standard thus creates a presumption that “false or misleading statements either have no benefits, or that the injury they cause consumers can be avoided by the company at very low cost.” This statement demonstrates the importance of truthfulness and transparency in the FTC’s jurisprudence: the law can assume that dishonest practices provide no benefits to consumers or to competition.

However, the focus of the “deceptive” standard is quite narrow because the disclosure regime it emphasizes is indifferent to whether and how consumers actually use the information disclosed. A 2008 FTC statement on the Commission’s role in regulating payday lending illustrates the limited applicability of the “deceptive” standard. The FTC only requires payday lenders to disclose their APRs so as to facilitate comparison shopping between payday loans. Disclosing APRs is an undeniably important goal; customers may be shocked to learn that typical payday loans impose APRs of between 300 and 400 percent. But the “deceptive” standard fails to address many of the deeper problems with payday lending, including their short terms, balloon payments, high costs, and the frequency of people who revolve these loans, paying new fees every month without decreasing the principal.

51. Id.
52. Research suggests that the formal design of an APR may lead certain consumers to be either over- or undersensitive to it. A standardized blanket disclosure that does not take into account this variation may not actually help many of those individuals make an optimal decision. Further analysis of this point is beyond the doctrinal scope of the deceptiveness standard; for more information see Massimo Caratelli, Transparency in Consumer Credit: The Usage of the APR, 17 PROC. AM. SOC. BUS. & BEHAV. SCI. 35 (Feb. 2010), available at http://asbbs.org/files/2010/ASBBS2010v1/PDF/C/Caratelli.pdf.
Again, disclosing the APR is a necessary step in raising awareness about the risks inherent to these loans. The “deceptive” standard, though, cannot go beyond this disclosure requirement to ensure that payday lenders work with borrowers to determine how or whether they will be able to pay back their loans. Nor can it require that lenders verify that their customers understand the term “APR,” or communicate the risks of being unable to pay back the loan.

To a large extent both the “abusive” and “deceptive” standards are concerned with what a consumer understands about an agreement at the moment of entering into it. However, the key distinction is that while deceptiveness requires the lender to affirmatively misrepresent or conceal information, the “abusive” standard may fault a lender who “takes unreasonable advantage of a lack of understanding.” This language, importantly, does not explicitly require that the lender created the lack of understanding. Where the “deceptive” standard has proven insufficient to create a new regime of clear, concise contracts, the “abusive” standard may provide a much-needed addition.

C. The Unfairness Standard Is Limited by a Balancing Test

The FTC’s other consumer protection standard—“unfair”—is distinct from the “deceptive” standard because it does not turn on whether the lender provided false information but rather on whether the substantive terms of the transaction are exploitative. Over the past fifty years, the “unfair” standard has shifted considerably in scope, narrowing to near inexistence in the early 1980s and then gradually returning in the late 1990s as a tool for curbing harmful practices that the “deceptive” standard could not reach. Under the current definition, an act is “unfair” only if it “causes substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.” The Commission may consider “established public policies” as evidence of unfairness, but such policies may not be the sole basis of their decision.

This standard is considerably narrower than the one it replaced, which allowed the FTC to prohibit practices that offended public policy, were

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56. 12 U.S.C. § 5531(d)(1)–(2)(A) (2006 & Supp. V 2011) (“Abusive—The Bureau shall have no authority under this section to declare an act or practice abusive in connection with the provision of a consumer financial product or service, unless the act or practice—(1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or (2) takes unreasonable advantage of—(A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service.”).
57. Id. § 5531(d)(2)(A).
58. Beales, supra note 50.
60. Id.
unethical or immoral, or caused substantial consumer harm. In 1978, the FTC used the old version of the standard in an attempt to restrict television advertising to children. Its bold proposal included banning television advertising to children under eight years old and either banning or modifying the advertising of sugary foods and drinks to children between ages eight and twelve. However, the FTC’s ambitions caused Congress such chagrin that it shut the agency down for a few days in 1980. Chastened, the agency rewrote the standard to make it clear that public policy and consumer harm were not on their own sufficient bases for finding unfairness. Hence, the current standard contains a balancing test meant to prevent the agency from overstepping its bounds.

As a result of this balancing test, even if the FTC finds that certain disclosures would prevent harm to consumers, it cannot find the absence of those disclosures to be unfair if the cost of disclosure would increase the price of the product or hamper competition to an extent outweighing the benefit to consumers. In other words, “unfairness” considers the potential impact of regulation on the market as a whole, including “increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation, and similar matters.” By assuming that consumers’ interests are inextricably bound up with the market, “unfairness” does not provide a way of resolving disputes when these interests and market forces diverge.

61. Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, Statement of Basis and Purpose, 29 Fed. Reg. 8355 (1964) (explaining that the broader standard had three prongs: (1) whether the practice “offends public policy”—as set forth in “statutes, the common law, or otherwise”; (2) “whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen”).


64. See Beales, supra note 50 (“Thus, the modern unfairness test reflects several common sense principles about the appropriate role for the Commission in the marketplace. First, the Commission’s role is to promote consumer choices, not second-guess those choices. That’s the point of the reasonable avoidance test. Second, the Commission should not be in the business of trying to second guess market outcomes when the benefits and costs of a policy are very closely balanced or when the existence of consumer injury is itself disputed. That’s the point of the substantial injury test. And the Commission should not be in the business of making essentially political choices about which public policies it wants to pursue. That is the point of codifying the limited role of public policy.”).

65. FTC Policy Statement on Unfairness, FED. TRADE COMM’N (Dec. 17, 1980), http://www.ftc.gov/bcp/policystmt/ad-unfair.htm (“A seller’s failure to present complex technical data on his product may lessen a consumer’s ability to choose, for example, but may also reduce the initial price he must pay for the article. The Commission is aware of these tradeoffs and will not find that a practice unfairly injures consumers unless it is injurious in its net effects.”).

66. Id.
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In a key decision in 1984, the FTC stated: “The principal focus of our unfairness policy is on the maintenance of consumer choice or consumer sovereignty.”67 This statement indicates that the underlying principle of the “unfairness” standard—facilitating and respecting consumer choice—overlaps with the “abusive” standard, which seeks to reduce complexity in order to make consumers’ choices more meaningful. At the same time, the “abusive” standard potentially reaches beyond the mandate of “unfairness” by permitting regulators to impose duties on lenders to, among other things, consider a borrower’s interests.

In addition to its development through case law, the FTC further defined the unfairness standard in 1984 with the Credit Practices Rule. This rule banned a number of practices as unfair, including confessions of judgment, wage assignments, security interests in household goods, waivers of exemption, pyramiding late fees, and cosigner liability68—in other words, the rule addresses the very types of acts that the CFPB was designed to address. During an extensive rule-making process, the FTC considered but rejected a number of other provisions that did not fall within the “unfair” standard. By analyzing these rejected provisions, a role for the “abusive” standard emerges.

One such rejected rule would have prohibited provisions in credit contracts that required debtors to pay the attorneys’ fees creditors incurred in debt-collection actions.69 The FTC found that the rule would have benefits, such as encouraging debtors with valid defenses to assert them in court and decreasing the size of judgments awarded against debtors, a “significant share” of which were likely attributable to attorneys’ fees.70 However, the agency found that because those benefits to borrowers could be canceled out by corresponding losses on the part of creditors, the rule would provide no net gain, only a shift of fixed costs between parties.71 Yet the FTC’s analysis fails to consider which party might be better suited to bear these costs, other barriers that might discourage debtors with valid defenses from asserting their rights in court, and society’s potential interest in debtors asserting their legal rights.72

The plain language of the “abusive” standard does not mention costs to creditors or to the credit industry, but rather focuses only on the consumer’s

70. Id. at 7784.
71. Id. at 7785.
72. In the same rule, the FTC rejected a proposal to ban the original unconscionable clause: cross-collateralization in the purchase of retail goods. The FTC found that the prevalence of harm was not clear enough to outweigh the cost it would impose on retailers for whom “the only security for the entire amount of the credit extended for the most recent purchase would then be a year-old appliance or piece of furniture.” Id. at 7786; see Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).
injury.\textsuperscript{73} In contrast to the “unfair” standard’s balancing test, Dodd-Frank imposes an obligation to consider countervailing benefits but does not make this consideration an element of the “abusive” standard.\textsuperscript{74} Thus, one key difference between the two standards is the greater flexibility accorded to the CFPB in weighing a rule’s potential to prevent consumer harm against other considerations.

Dodd-Frank’s more flexible approach to assessing the impacts of regulation would allow the CFPB to restrict acts or practices that harm one group of consumers to benefit another. For example, the high fees and interest rates incurred mostly by low-income credit card holders are used to fund rewards programs that are generally enjoyed by those who are more financially secure.\textsuperscript{75}

Under the FTC’s “unfair” standard, regulators could determine whether the harm experienced by cardholders in serious debt outweighs the benefit that accrues to the many who enjoy free checking accounts and other perks of card ownership. When considered in light of increasing economic inequality,\textsuperscript{76} this arrangement seems wrong and even dishonest. While some consumers fall behind in payments because of purchases that they could have avoided, many others are caught unawares by an unforeseen event such as an illness, emergency repair, or decrease in salary.\textsuperscript{77} Many cardholders irrationally discount the likelihood that they will end up revolving a large balance or paying penalty fees, and thus do not sufficiently account for these costs when selecting a card.\textsuperscript{78} On the other hand, annual or per-transaction fees are much easier to understand up front and to budget for. From this perspective, it would

\textsuperscript{73} It is important to note, however, that the statute does not define which interests regulators should be most concerned about. Some have suggested that the CFPB’s regulations will increase the costs of all consumer financial products. Regulators in that situation will have to determine whether this redistribution of costs—from those consumers who sustain serious losses to the entire consumer marketplace—is desirable.


\textsuperscript{75} See Andrew Martin, Bank of America to End Debit Overdraft Fees, N.Y. TIMES, Mar. 10, 2010, at B1 (“In the past, a relatively small number of customers generated such enormous fees from overdraft charges and penalties on credit cards that they subsidized free checking and generous rewards programs for the majority of customers.”); Scott Schuh et al., Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations, CONSUMER PAYMENTS RESEARCH CTR. (Aug. 31, 2010), http://www.bos.frb.org/economic/ppdp/2010/ppdp1003.pdf (study by the Federal Reserve Bank of Boston showing that families that use cash subsidize credit card rewards programs); Oren Bar-Gill, Seduction by Plastic, 98 NW. U. L. REV. 1373, 1377 (2004) (“The systematic overpricing of credit services and underpricing of transacting services means that transactors are being cross-subsidized by borrowers.”).

\textsuperscript{76} See, e.g., Timothy Noah, The United States of Inequality, SLATE (Sept. 3, 2010), http://www.slate.com/id/2266025/entry/2266026.

\textsuperscript{77} See, e.g., A. Mechele Dickerson, Consumer Over-Indebtedness: A U.S. Perspective, 43 TEX. INT’L L.J. 135, 146 (2008) (“But empirical data collected by prominent U.S. academics show this is not the case; medical debts, a divorce, or a job interruption cause most consumer bankruptcies in the United States.”).

\textsuperscript{78} Bar-Gill, supra note 75, at 1374–80.
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be more equitable for all users to pay clearly disclosed up-front fees than for a small number of economically unstable borrowers to pay considerably more than they expected in order to subsidize free offerings to borrowers with greater financial resources.

“Abusive” provides a more flexible approach than the “unfairness” standard.79 Under the “unfairness” test, regulators must engage in a potentially complicated balancing of costs and benefits before applying a rule. However, considering the distributional inequity inherent in the current model, a regulator could use the “abusive” standard to limit interest rates, fees, or other product features despite the impact of such limitations on the market.

D. The Doctrine of Unconscionability Is Narrowly Applied, Difficult to Prove, and Only Redresses the Most Egregious Abuses

Unconscionability provides a defense to parties being sued for breach of contract by permitting courts to refrain from enforcing specific terms or entire contracts that they find unconscionable. Because the Uniform Commercial Code codifies the framework but not the substance of this defense,80 states have developed varying interpretations through the common law. The doctrine was first fully articulated in a 1965 case that held unconscionable a credit contract for the purchase of retail goods containing a cross-collateralization provision that triggered the repossession of all the furniture owned by a low-income family.81 This precedent suggests that unconscionability is ideally suited for protecting consumers from abusive lending practices. However, courts have generally applied the unconscionability doctrine narrowly.82 Further, it functions only to prevent the enforcement of particular contracts, it does not generally provide for damages, and does not prevent people from entering into unenforceable contracts.83

79. In a recent House hearing, CFPB Director Rich Cordray acknowledged that practices can be abusive without being unfair and offered the example of a lender convincing an elderly widow who had nearly paid off her mortgage to refinance her home with an exotic loan. He noted that if the same loan were offered to a sophisticated investor, it might not be abusive. House Panel Grills Consumer Protection Chief on What Defines ‘Abusive’ Lending Practice, BLT: BLOG OF LEGAL TIMES (Mar. 29, 2012), http://legaltimes.typepad.com/blt/2012/03/house-panel-grills-consumer-protection-chief-on-what-defines-abusive-lending-practice-.html.

80. U.C.C. § 2-302 (2003) (“(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.”).


82. See, e.g., 8 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS, § 18:8 (4th. ed. 2010) (“The principle [of unconscionability] is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power.”); Id. § 18:15 (“The mere assertion that the price was excessive has thus been deemed conclusory and insufficient to establish the defense of unconscionability.”)

83. Id. § 18:17 (If a court finds a contract unconscionable, the available remedies are to “refuse to enforce the agreement in its entirety, to delete the unconscionable clause and enforce the remainder
In order to make a finding of unconscionability, a court must apply a two-pronged sliding-scale test. One prong is procedural unconscionability, which refers to the process by which the agreement was reached. Courts assess factors like small print, hidden terms, overly technical language, insufficient time for one party to review the terms, and difference in bargaining power under this prong. The second prong is substantive unconscionability, which looks at the substance of the terms themselves. This prong focuses on terms so harsh or one-sided that they shock the conscience. While a stronger showing under one prong may require a lesser showing under the other, both prongs must be at least minimally satisfied.

Unfortunately, courts have interpreted unconscionability narrowly to serve as a backstop to the most extreme abuses rather than as a tool for reforming a broken system. A 2010 case from the Ohio Court of Appeals provides a useful example of the doctrine’s limits and the gap it leaves for the “abusive” standard to fill. Defendants, the Pevarski family, began experiencing financial difficulties after Glenn, the husband, suffered a spinal cord injury in 2001. Behind on their credit card debt, they decided to refinance their home. After being contacted by an Ameriquest loan officer, Glenn explained that they were interested in refinancing their home with a fixed-rate thirty-year mortgage that would pay off their outstanding debt. He gathered their financial information and faxed it to Ameriquest. The loan officer then called Glenn back and told him that Ameriquest could give them a thirty-year mortgage fixed at the rate of 5.75 percent, and so the Pevarskis scheduled a closing.

However, the documents that Ameriquest sent in advance of the closing indicated that the loan had a variable interest rate and would not pay off their outstanding debt. Glenn called the loan officer who said he had made a mistake but that the Pevarskis should sign the documents anyway. The Pevarskis refused and Ameriquest rescheduled the closing. Once again, though, Ameriquest provided documents listing a variable-rate loan that did not

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84. Id. § 18:10.
85. Id.
86. Id.
87. Id.
88. Id.
90. Id. at 891.
91. Id.
92. Id.
93. Id. at 891–92.
94. Id.
95. Id.
96. Id.
97. Id.
pay off the Pevarskis’ existing debt.\textsuperscript{98} Glenn alleged that when he called the loan officer he was told that he “should not worry about it,” that Ameriquest had to “work” the loan this way, and that Ameriquest would refinance the loan before the interest rate increased.\textsuperscript{99} In reliance on these statements, the Pevarskis signed the documents and paid nine thousand dollars in closing costs.\textsuperscript{100}

The Pevarskis later discovered that Ameriquest overstated both their income and assets on their loan application, in spite of the fact that the couple provided the lender with correct financial information.\textsuperscript{101} Although this may seem like it was in the Pevarskis’ interest, there is evidence that at some banks overstating borrower income was a way for loan officers to earn bonuses by qualifying prime-rate borrowers for more expensive subprime loans.\textsuperscript{102} In any event, it is clear that the Pevarskis did not ask Ameriquest to do this and were not told that this was done, and that Ameriquest ultimately approved them for a loan they could not afford.

The Pevarskis then attempted to refinance their loan through Ameriquest before their interest rate increased—as they had been told they would be able to do—but were denied.\textsuperscript{103} At the first interest-rate adjustment, their monthly payments increased from $1097 to $1327.\textsuperscript{104} The Pevarskis were still experiencing financial difficulty and could not afford the increased payments.\textsuperscript{105} A few months after the rate increase, they stopped making mortgage payments and finally Deutsche Bank, the note-holder, filed a claim for foreclosure.\textsuperscript{106}

In defending against the foreclosure action, the Pevarskis argued in part that their agreement with Ameriquest was unconscionable.\textsuperscript{107} The trial court rejected this claim on a motion for summary judgment that the appellate court upheld.\textsuperscript{108} The appellate court’s holding was based on the following: the Pevarskis’ monthly payments did not increase immediately after the refinancing and in fact decreased temporarily; they received over $25,000 in cash at closing; and their interest rate increased from 6.3 percent to only 11.125

\begin{flushleft}
\textsuperscript{98} \textit{Id}.
\textsuperscript{99} \textit{Id}.
\textsuperscript{100} \textit{Id}.
\textsuperscript{101} \textit{Id} at 892.
\textsuperscript{103} 932 N.E.2d at 893.
\textsuperscript{104} \textit{Id}.
\textsuperscript{105} \textit{Id}.
\textsuperscript{106} \textit{Id}.
\textsuperscript{107} \textit{Id} at 897–98.
\textsuperscript{108} \textit{Id}.
\end{flushleft}
percent, which was “dramatic” but not “in and of itself, so extreme as to appear unconscionable.”\textsuperscript{109}

The Pevarskis’ case provides an example of how narrowly courts have construed the unconscionability doctrine. The Pevarskis reasonably relied on their loan officer’s promise that if they signed the paperwork, they would eventually be able to get a loan with the terms they sought. They relied on representations made by a loan officer that they would be able to adjust this loan before it was too late. They were repeatedly confronted with documents that they did not understand. Their loan officer appears to have misstated their financial information in their loan application. And yet, because the court found the terms of their loan to be insufficiently punishing, and because the loan bought them some time to try to get back on their feet, the court did not deem the contract unconscionable. Instead, the court characterized it as a simply “bad deal,” stressing that “courts may not invalidate every bad deal on the grounds of unconscionability.”\textsuperscript{110}

This case shows how common law procedural and evidentiary rules impede consumers’ ability to rely on unconscionability for protection against abusive practices. Not only were the terms of the Pevarskis’ loan not deemed sufficiently unfair to bar enforcement, the court also excluded much of the evidence buttressing their claims of shady dealing as parol evidence.\textsuperscript{111}

The doctrine of unconscionability and Dodd-Frank’s new “abusive” standard seek to address many of the same concerns. For example, a practice that takes unreasonable advantage of a consumer’s “lack of understanding”\textsuperscript{112} suggests the kinds of procedural concerns that fall under the first prong of unconscionability. Such concerns include contracts that bury terms in fine print and lenders who bully customers or offer them adhesive contracts. The “abusive” standard is also concerned with substantively unfair terms such as terms that shift more risk to the consumer than he or she can reasonably bear or terms that trigger harsher contractual terms for a nonmaterial consumer breach that far outstrip the actual loss to the lender.

\textsuperscript{109} Id. It is worth noting that this rate, while perhaps not high enough to shock the court’s conscience, was close to double the 2006 average of 6.41 percent for fixed-rate thirty-year mortgages. See \textit{30-Year Fixed-Rate Mortgages Since 1971}, FREDDIE MAC, http://www.freddiemac.com/pmms/pmms30.htm (last visited Aug. 4, 2012).

\textsuperscript{110} 932 N.E.2d at 898.

\textsuperscript{111} Agreements and negotiations prior to or contemporaneous with the adoption of a writing are admissible in evidence \textit{[only]} to establish (a) that the writing is or is not an integrated agreement; (b) that the integrated agreement, if any, is completely or partially integrated; (c) the meaning of the writing, whether or not integrated; (d) illegality, fraud, duress, mistake, lack of consideration, or other invalidating cause; (e) ground for granting or denying rescission, reformation, specific performance, or other remedy. \textsc{Restatement (Second) of Contracts} § 214(d) (1981).

The “abusive” standard, however, offers considerably greater protection to consumers than unconscionability. How might the Pevarski case have come out differently under the “abusive” standard? A reasonable interpretation of the statutory language would fault the loan officer at Ameriquest for moving forward on a loan that the Pevarskis did not understand and for faxing documents to sign without sufficiently explaining them, since this behavior likely constitutes taking unreasonable advantage of their lack of understanding, even though it did not rise to the level of procedural unconscionability. Because the Pevarskis were repeatedly denied the loan that they requested and their information was inaccurately recorded or changed on key forms, they were rendered unable to protect their own interests. Nevertheless, the loan they received was not one-sided enough to be substantively unconscionable. This case demonstrates the way that the “abusive” standard subtly but crucially shifts responsibility from borrower to lender.

II. LEGISLATIVE INNOVATION: CONGRESS VENTURES BEYOND UNFAIRNESS AND DECEPTION

The text and legislative history of the Dodd-Frank Act suggest that the “abusive” standard emerged in response to reported distortions in the market for consumer financial products—distortions that standards based upon unfairness, deceptiveness, and unconscionability could not reach.

The history of the Dodd-Frank Act begins with the idea for a Consumer Financial Protection Agency, which originated in the Obama administration. In a Treasury Department whitepaper outlining its proposal, the administration made reference to the types of market failures that led to the recent economic crisis: “Households saw significant increases in access to credit, but those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations that they did not understand and could not afford.” The statement acknowledged the limits of the current disclosure regime and the problems created by inadequate consumer understanding.

Building on its findings of market failure, the administration went on to advocate for more than just disclosure rules. It stressed the need to present information in a way that actually helps consumers make decisions and to test the effectiveness of disclosures in the field. It also offered a standard—

114. Treasury Department Whitepaper, supra note 25, at 2.
115. Id. at 63 (“Mandatory disclosure forms should be clear, simple, and concise.”).
116. Id. at 63–64 (“A regulator is typically limited to testing disclosures in a ‘laboratory’ environment. A product provider, however, has the capacity to test disclosures in the field, which can produce more robust and relevant results. . . . We propose that the CFPA should be authorized to establish standards and procedures, including appropriate immunity from liability, for providers to conduct field tests of disclosures.”).
“reasonableness”—that would reach beyond the “deception” standard and hold lenders accountable for failing to inform and educate their customers.\textsuperscript{117}

In addition to introducing the issue of market failure into the legislative discussion surrounding consumer finance, the Obama administration introduced the term abusive as a consumer financial protection standard by tacking it onto the familiar string of unfair and deceptive, without further elaboration.\textsuperscript{118} The administration did not provide any additional definition of abusive when it promulgated the Consumer Financial Protection Agency Act of 2009, which gave the CFPA the power to regulate abusive practices.\textsuperscript{119} In fact, the “abusive” standard remained entirely undefined until the House of Representatives passed the Wall Street Reform and Consumer Protection Act in December 2009.\textsuperscript{120}

The House’s definition of abusive echoed the administration’s concerns about market failure caused by consumer confusion and the persistence of dangerous products on the market. However, the House limited the scope of the standard to encompass only those practices that in addition to harming consumers also threaten the stability of the market. When the Senate received the House bill, it changed this conjunctive test into a disjunctive test, expanding the reach of the standard.\textsuperscript{121} Without the conjunctive constraint, the Senate’s expanded definition—which became law in July 2010\textsuperscript{122}—focused entirely on preventing injury to consumers and could be invoked to prevent injury even when there was no risk to market stability.

Aside from the evolving definition of abusive, there is little in the legislative record to further flesh out what exactly the term might entail. Witnesses at a July 2009 Senate hearing used the term abusive to refer generally to harmful practices, but failed to engage in an in-depth discussion of exactly what the term meant or how it would be applied.\textsuperscript{123} Travis Plunkett, the Legislative Director of the Consumer Federation of America, provided in his testimony before the Committee a list of practices he referred to as “abusive

\textsuperscript{117.} Id. at 64 (“Reasonableness includes balance in the presentation of risks and benefits, as well as clarity and conspicuousness in the description of significant product costs and risks. This is a higher standard than merely refraining from deception. Moreover, reasonableness does not mean a litany of every conceivable risk, which effectively obscures significant risks. It means identifying conspicuously the more significant risks. It means providing consumers with disclosures that help them to understand the consequences of their financial decisions.”).

\textsuperscript{118.} Id. at 67–68 (“[T]he CFPA should assume the statutory authorities to regulate unfair, deceptive, and abusive acts or practices for all credit, savings, and payment products. The legal standards for these authorities are generally well-established and would require the CFPA to develop a record and weigh costs and benefits before exercising these authorities.”).

\textsuperscript{119.} Id. at 67–68.

\textsuperscript{120.} H.R. 4173, 111th Cong. § 1031(d) (2009).

\textsuperscript{121.} S. 3217, 111th Cong. § 1031(d)(1)–(2) (2009).


lending practices,” including penalty rates over 30 percent, increasing interest on outstanding balances, aggressive marketing of credit cards to young people, and universal default.124

At a House hearing that fall, Representative Hensarling asked NAACP Director Hilary Shelton whether a payday loan of two hundred dollars with sixty dollars in finance charges would be unfair, and Mr. Shelton responded that he thought capping the APR at 36 percent, as the government had done for service members, would be appropriate, and that a more expensive loan would indeed be abusive.125 Representative Hensarling then turned to Janis Bowdler of the National Council of La Raza (NCLR) and asked whether she considered a card that imposed a universal default rate but provided a lower rate of interest to be abusive.126 Ms. Bowdler responded that the NCLR recommended evaluating products based on whether they had a disparate impact on minority communities, not an abstract appraisal of their features.127

Although the substantive on-the-record discussion of the “abusive” standard is thin, other discussions about the consumer protection functions of Dodd-Frank contain useful clues as to how the standard might be used. In contrast to the definition of abusive that expanded as the bill evolved, other areas of the CFPB’s power contracted. Several novel and specific provisions were removed, most notably the requirement that lenders offer “plain vanilla” products alongside more complicated ones128 and the requirement that disclosures be “reasonable.”129 Examining the nature of the abandoned provisions and the arguments made by their supporters and detractors reveals both the goals of regulators (reforming the consumer financial market) and the resistance of lenders to these reforms. These arguments demarcate the terrain in which the battle over implementing the “abusive” standard will be fought.

One of the most controversial of the removed proposals, the “plain vanilla” provision, would have empowered the CFPB to define certain straightforward products with easily identifiable risks as “standard.”130 Lenders offering more complex products would have been required to offer the standard

124. Id. at 79–108 (statement of Travis B. Plunkett, Legislative Director, Consumer Federation of America).
126. Id. at 25–26.
127. Id. at 26.
128. Id.
129. Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. § 1036 (“(a) CHARACTERISTICS OF STANDARD CONSUMER FINANCIAL PRODUCTS OR SERVICES.—Subject to rules adopted by the Agency under this section, a standard consumer financial product or service is one that—(1) is or can be readily offered by covered persons that offer or seek to offer alternative consumer financial products or services; (2) is transparent to consumers in its terms and features; (3) poses lower risks to consumers; (4) facilitates comparisons with and assessment of the benefits and costs of alternative consumer financial products or services; and (5) contains the features or terms defined by the Agency for the product or service.”).
130. Id.
product as well, as a benchmark or framing device. On July 14, 2009, the Senate Committee on Banking, Housing, and Urban Affairs held a hearing that provides insight into why the “plain vanilla” provision did not survive: it faced intense hostility from the financial industry and certain members of Congress.131

Senator Corker voiced the standard criticism that the “plain vanilla” requirement would somehow hurt “boutique” companies that wanted to offer “niche” products without also providing a set of standard products.132 At the end of the round of questioning, he amplified his critique by characterizing the provision as being essentially un-American because it would stifle innovation.133 This argument ignores the fact that many of these “innovations” are sold to people who can neither understand nor afford them, rather than to a niche clientele.

Peter Wallison, testifying on behalf of the American Enterprise Institute, echoed Senator Corker’s fears about the consequences of the “plain vanilla” provision and brought up a related concern about the invasiveness of assessing consumer understanding. Conceding that levels of financial understanding vary, he asserted that such differences “should be ignored in favor of the higher ideal of equality” and that any other course of action would risk “invidious or arbitrary discrimination.”134 One striking aspect of this statement is its use of language that invokes civil rights, which is somewhat perverse given that many prominent civil rights organizations have raised concerns about lenders making targeted sales of subprime mortgages to minorities.135 Wallison continued in this vein, citing the Treasury Department’s proposal that the CFPA “require providers to have applicants fill out financial experience questionnaires” to determine eligibility for alternative mortgages.136 Wallison’s comparison of this idea to a “literacy or property test for voting” raised the specter of racial discrimination.137 Wallison’s charged rhetoric demonstrates the political

132. Id. at 16.
133. Id. at 17.
134. Id. at 134.
135. Perspectives on the Consumer Financial Protection Agency: Hearing Before the H. Comm. on Fin. Servs., 111th Cong. 9 (2009) (statement of Hilary O. Shelton, Director, Washington Bureau, National Association for the Advancement of Colored People) (“Examples of financial abuses, targeting racial and ethnic minorities abound, especially in the mortgage arena, where predatory lenders consistently target certain groups and communities, and by abusive credit card companies and exploitive payday lenders.”).
136. Id.
137. Id. Wallison did, however, acknowledge that such distinctions are routinely made on behalf of wealthy investors but drew a distinction between consumer credit and securities on the basis of traits. He thought that the harm of being denied consumer credit is greater than the harm of being told a security is unsuitable for investment purposes, and investors often have ongoing relationships
challenges the CFPB will face in requiring lenders to assess and enhance consumer understanding.

In defense of the “plain vanilla” provisions, Professors Michael Barr and Sendhil Mullainathan fielded numerous questions about whether bureaucrats were smarter than average Americans and why they were so bent on destroying consumer freedom.138 The professors grounded their responses in behavioral economics as a way to explain persistent consumer errors that banks exploit.139 Mullainathan explained that certain situations are more conducive to rational decision making, and that policy could be used to enhance consumers’ ability to make decisions by lightly regulating safer products while imposing strict rules on more complex offerings.140 He explained that while better disclosures were certainly needed, even perfect disclosure would not be sufficient to prevent the sale of welfare-reducing financial products in all instances.141 Both advocates defended the “plain vanilla” provision as a restriction that would be minimally burdensome to lenders but would go a long way in improving consumer decision making.142 Standard products would provide consumers a benchmark from which to assess risk and help highlight the risks of more elaborate products.

The other provision in the House’s bill that provoked a harsh backlash was the requirement that disclosures be “reasonable.”143 The bill defined a reasonable disclosure as one that “communicate[s] significant risks and costs in a clear, concise, and timely manner designed to promote a consumer’s awareness and understanding of the risks and costs, as well as to use the information to make financial decisions.”144 Importantly, it contained no safe harbor for lenders using “model” disclosures designed by the CFPB, thus placing the burden of determining reasonableness on lenders rather than on regulators.145 Edward Yingling, President and Chief Executive Officer of the American Bankers’ Association, said the term was “so vague no banker and no

with brokers who are more likely to understand their needs than consumer lenders understand the needs of their borrowers.

139. Id. at 59–66, 136–40 (statement of Michael S. Barr, Assistant Secretary for Financial Institutions, Department of the Treasury), (statement of Sendhil Mullainathan, Professor of Economics, Harvard University).
140. Id. at 136.
141. Id. at 138–39.
142. Id. at 64–65, 139–40.
144. Id.
145. Id.
lawyer would know what to do with it,” and that it was an “unworkable standard that [would] cause tremendous uncertainty for years to come.”

The concern about “reasonableness,” like the concern about “plain vanilla” products, was at its heart a concern about who would bear certain risks. Consider a consumer who buys a payment-option adjustable-rate mortgage and is later forced into foreclosure by unaffordable monthly payments. Will the broker be exposed to liability, either for failing to inform the consumer about the loan or for selling it despite signs that it was unaffordable? The breadth of that potential liability remains at stake as regulators continue to craft and implement the “abusive” standard.

In late September 2009, Representative Frank sent a memorandum to the Democratic members of the House Committee on Financial Services summarizing changes made to the bill in response to concerns voiced at the hearings. According to this memorandum, the CFPA’s mandate is limited to adjusting the disclosure regime to improve “clarity, simplicity, conciseness, and reduction of regulatory burden.” The memorandum definitively removed the “plain vanilla” provision and asserted that banks would be placed in an “untenable” position if they had to determine whether consumers actually understood the products they were purchasing. Thus, the final version of Dodd-Frank created a safe harbor for any lenders using a model form issued under the rule.

III.
THREE MAIN PROBLEMS LIE BEYOND THE REACH OF THE CURRENT DISCLOSURE REGIME

As we have seen, consumer finance is governed by a set of intersecting standards and rules drawn from contract law and statutes that employ differing enforcement mechanisms and penalties. Together they form the “disclosure regime”—a legal framework premised on the idea that left to their own devices, rational and well-informed agents will freely enter into agreements that they expect will be mutually beneficial. Unfortunately, consumers do not

147. Id.
149. Id.
151. See, e.g., WILLISTON & LORD, supra note 82, at § 31:4 (“[T]he law presumes that the parties understood the import of their contract and that they had the intention which its terms manifest.”).
consistently conform to this ideal of rational decision making.\textsuperscript{152} In fact, under the disclosure regime, consumer credit contracts have become more difficult to understand while the pretense that anyone reads these documents has grown thinner and weaker.\textsuperscript{153}

By shifting attention from disclosure to understanding, the “abusive” standard could help consumers to select financial products that will enhance their welfare. Better choices would in turn spur lenders to provide safer and more valuable products instead of competing to create novel forms of credit that shift risk from lenders to borrowers. And the “abusive” standard also recognizes the limits of disclosure: products that are designed to sink struggling consumers into serious financial trouble require more than a warning label. By acknowledging that there are certain transactions in which consumers cannot protect their own interests, the “abusive” standard provides a basis for modifying products when they are designed to counter consumers’ interests.\textsuperscript{154}

\textbf{A. The Lack of Consumer Awareness Surrounding Financial Products}

As the evidence mounts that many consumers neither read nor understand the financial agreements into which they enter, new theories have emerged that describe how consumers actually interact with contractual language, how they make decisions, and the implications of their decisions on their own well-being

\textsuperscript{152} Professor Rashmi Dyal-Chand argues that the reliance on disclosure is part of a paradigm unique to credit card regulation as contrasted with the laws governing mortgages, and that the tension between these two models of borrowing is not tenable in the longer term. Rashmi Dyal-Chand, \textit{From Status to Contract: Evolving Paradigms for Regulating Consumer Credit}, 73 TENN. L. REV. 303, 304–05 (2006).

\textsuperscript{153} Omri Ben-Shahar & Carl E. Schneider, \textit{The Failure of Mandated Disclosure}, 15–16 (Univ. of Chi. Law Sch., John M. Olin Law & Economic Research Paper No. 516, 2010), available at http://www.law.uchicago.edu/files/file/516-obs-disclosure.pdf (citing studies showing that TILA has had a very limited impact and has not improved the terms of consumer financial contracts). Elizabeth Warren has also publicly decried the current system. See Jim Puzzanghera, \textit{Q&A: Elizabeth Warren: “This Agency Must Belong to the People”; Financial Protection Bureau She’s Building Is Already Making a Difference, She Says}, L.A. TIMES, Oct. 26, 2010 at B1, (“Disclosure has come to be a dirty word. Disclosure has become like shrubbery, a dense thicket of words that are a good place to hide tricks and traps.”). Professor Jeff Sovern has voiced similar concerns. See \textit{Preventing Future Economic Crises Through Consumer Protection Law or How the Truth in Lending Act Failed Subprime Borrowers} 22 (St. John’s University, Sch. of Law, Legal Studies Research Paper Series, Working Paper No. 10-0189, 2010), available at http://ssrn.com/abstract=1531781 (“When combined with the erroneous disclosures, the survey produces ironic results. It may not matter that the forms are misleading, because few borrowers attend to them. And it may not matter that few borrowers attend to them, because the forms are misleading.”).

and on the functioning of the marketplace. These descriptive accounts have paved the way for new normative ideas about which terms and agreements the legal system should enforce. The strand of reasoning that leads directly to the “abusive” standard posits that when consumers do not understand the risks and dangers of the products they buy, the market lacks incentives to develop and market safer or more valuable products.

The influential article “Making Credit Safer”—in which Elizabeth Warren and Oren Bar-Gill proposed an agency to regulate consumer financial products—provides a detailed explanation of how a lack of consumer understanding has led to breakdowns in the consumer financial market. “The complexity of credit products” tops their list of factors that make financial products “particularly dangerous” because complexity “prevents effective comparison-shopping and hinders competition.” In other words, complexity interferes with the forces that typically protect consumers in the marketplace.

Professors Warren and Bar-Gill review empirical evidence demonstrating that most consumers do not fully understand the terms of credit products and offer reasons for why this remains the case. In addition to the possibility that some consumers may believe they are informed when they are not, or may not see the value of understanding terms that they expect will never apply to them, the extremely complicated nature of contracts makes it impossible for most people to make sense of them. Thus, in arguing for the creation of the CFPB,

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157. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. Pa. L. Rev. 1, 8 (2008) (“Markets and contracts can be relied upon to maximize welfare only when consumers are rational and informed. If consumers do not know what they are buying, markets might not give them what they would have bought had they known.”).

158. Id. at 10.

159. Id. at 40–41 (discussing a study on the effects of complexity in the subprime mortgage market).


162. Id. at 13.
Professors Warren and Bar-Gill made it clear that the Bureau would have to start by reducing complexity.

Following in this vein, Director Rich Cordray stated in his video introduction on the CFPB website: “Consumers need to be able to fully understand the costs and risks of borrowing and they need to be able to comparison shop for the best deal.” It is not surprising, then, that two of the CFPB’s initial projects are to simplify mortgage disclosures and credit card contracts. In developing these materials, the CFPB is making heavy use of consumer feedback and testing in an effort to ensure that the forms are widely comprehensible.

These contracts are complicated not only because of their language but also because their effects will only unfold over time and will vary according to an individual consumer’s behavior. When it was difficult for lenders to assess a consumer’s credit risk, penalty fees and high interest rates were necessary in order to deter and compensate for default, and to reveal consumer preferences and their likely future behavior. Today, however, card issuers accumulate massive amounts of data on consumer spending, which often allow them to know much more about cardholders’ likely future spending patterns than cardholders themselves do. Professors Warren and Bar-Gill explain that when it comes to borrowing and spending behavior, population-level data that includes exogenous factors like employment trends and rates of illness may be more salient than an individual consumer’s intentions upon opening a credit card. Since the balance of information has shifted over the past twenty years, models of the consumer financial market must shift, too.

As the former General Counsel of Citigroup’s North American and European credit card business explained: “No other industry in the world knows consumers and their transaction behavior better than the bank card industry. . . . The mathematics of virtually everything consumers do is stored, updated, categorized, churned, scored, tested, valued, and compared from every possible angle in hundreds of the most powerful computers and by among the

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165. See CONSUMER FIN. PROT. BUREAU, supra note 164, Know Before You Owe; CONSUMER FIN. PROT. BUREAU, supra note 164, Know Before You Owe: Credit Cards.

166. See Bar-Gill & Warren, supra note 157, at 23.


169. See id. at 23–24.
most creative minds anywhere." 170 It is hard for consumers to anticipate their own spending because it may be impacted by events beyond their control—events that do not tend to happen often in the lifetime of any one individual and so are difficult to anticipate without recourse to aggregated data, much of which is undoubtedly either proprietary or protected by privacy laws.

B. The Proliferation of Dangerous Products

In speeches and articles, Professor Warren has articulated the mission of the CFPB by using a toaster as a metaphor for consumer financial products. 171 Though we don’t typically think of toasters as dangerous, an exploding toaster could cause serious harm. Hence, safety regulations on this seemingly innocuous product are essential to ensure that dangerous products do not reach the market. This metaphor makes the idea of financial regulation seem more concrete, more practical, and more urgent. However, the immediacy of this image hides the difficulty of the question it raises: What exactly makes a financial product “dangerous” in the way that a toaster is potentially dangerous? In other words, if we believe that a lack of understanding is causing consumers to purchase the “wrong” products, what exactly makes them wrong?

Accounts of consumers’ experiences leading up to and following the economic downturn suggest several ways of identifying danger in the context of financial products. First, there are products that change suddenly, such as credit cards with interest rates that spike if a consumer makes a late payment. 172 Next, some products are marketed aggressively to people whom the lender knows or should know cannot afford them, such as residents of Section 8 housing who are inundated with credit card offers on a daily basis. 173 Finally, certain products encourage their own misuse, including credit cards with low introductory rates. 174

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170. Id. at 24. See also Kathleen C. Engel & Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 Tex. L. Rev. 1255, 1336 (2002) (“Lenders can draw on extensive proprietary databases with past repayment histories of borrowers to predict borrowers’ risk thresholds and ability to repay. For decades, lenders have relied on underwriting guidelines that are based on similar predictions in deciding whether to make loans. Certainly, they can use those same guidelines to determine whether borrowers can afford their repayment obligations.”).


172. Pew Health Grp., Two Steps Forward: After the Credit Card Act, Credit Cards Are Safer and More Transparent—But Challenges Remain (2010), available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Credit_Cards/PEW-CreditCard%20FINAL.PDF?n=1231 (“Even under new regulations, penalty interest rate practices remained widespread. At least 94 percent of bank cards and 46 percent of credit union cards included penalty rate terms. Where disclosed, the median penalty rate rose by one percentage point from July 2009, to 29.99 percent.”).


174. See Bar-Gill, supra note 75, at 1377.
One way of understanding the “danger” posed by financial products is by examining products that are designed to appeal to consumers’ imperfect rationality. Professor Bar-Gill discusses credit card pricing practices in this context. Many credit cards offer a very low or even nonexistent interest rate for an introductory period followed by a sharp increase for the duration of the card’s use. Credit card companies presumably lose money early on in the agreement since they do not have access to free capital. However, this investment yields large returns in the long run: studies show that most borrowing takes place at the higher interest rates that kick in after the introductory period. Teaser rates and other features of the credit card pricing model maximize appeal to consumers, who are in the aggregate prone to making certain common errors. Consumers tend to systematically underestimate the amount of money they will want to borrow in the future, believe they will switch to a card with a lower rate if they do need to borrow, believe they will not miss payments, and believe they will be able to pay their bill down in a short amount of time. Because consumers do not have an accurate picture of how they will use credit products, they are not adequately sensitive to the product features that will govern the price they actually pay.

Professor Bar-Gill notes that because credit card companies make most of their money from customers who incur penalties and pay high penalty rates, customers in worse financial shape are perversely more attractive: “The practice of charging default rates of interest, which often run into the 20 percent and 30 percent range, makes customers who give the clearest sign of trouble—missing payments—among the most profitable for the issuers.” Others, noting the same tendency, have described the credit card business model as a “sweatbox” because it splits the risks of lending from its rewards. In short, lenders may prefer consumers who are more likely to fall behind on their payments, as these consumers will be made to “sweat” out high fees in the process. Card companies are not concerned that card holders will ultimately go into default or bankruptcy, as long as these customers continue paying high fees and interest rates for a certain amount of time.

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175. Id. at 1392.
176. Id.
177. Id. at 1391.
178. Id. at 1395–1401.
179. Id. at 1393.
181. Id. at 417 (“The sweatbox model of credit card lending is built on not only accepting, but affirmatively soliciting borrowers who will likely have a hard time repaying their debt.”).
182. Id. (“Even if the lender knows that his loan is highly likely to bankrupt the debtor and be written off in whole or in part, he does not care because he makes back his investment in penalty interest and fees relatively quickly regardless of the remaining principal balance. Once this point passes, he is content to let the chips of his improvident loan fall where they may, indifferent to the harm on the debtor and the potential externalities imposed on others.”).
The sweatbox introduces a serious rift between the interests of the borrower and those of the lender. This is especially troubling because it places the burden of high fees on borrowers who intend to repay their loans, and thus the steeper payments do not serve to check any moral hazard on the part of borrowers. In fact, a consumer who is indifferent to the prospect of default can “strategically default” by declaring bankruptcy earlier in the process. It is those borrowers who want to pay back the money they were lent who generate the most staggering profits for the industry.

Of course, in every loan there is an unavoidable gap between the interests of the borrower and the lender. For example, a lender will earn more interest from a borrower who takes longer to repay a loan, making a loan that is more profitable for the lender more costly to the borrower. As a rule, however, the traditional lender will not earn a profit if the borrower makes payments initially but ultimately defaults on the loan. Credit card companies distort this model by extending credit that they expect will eventually push a borrower into default in order to extract high fees up front. Ultimately, the sweatbox causes harm to consumers when they are at their most vulnerable, thereby reinforcing existing patterns of inequity and reducing overall welfare.

C. Lenders’ Incentives to Mislead Borrowers

A third source of market failure is consumers’ misplaced reliance on the sellers of financial products to act in their best interests when, in fact, such sellers are under no such obligation. Michael Barr, Sendhil Mullainathan, Eldar Shafir, Patricia McCoy, and Kathleen Engel have explored the need to

183. A corollary in the housing market is to walk away from a mortgage once the value of the loan exceeds the value of the house. See Todd J. Zywicki & Joseph D. Adamson, The Law and Economics of Subprime Lending, 80 U. COLO. L. Rev. 1, 27 (2009) (“Under the option theory, therefore, foreclosure is essentially a voluntary and rational response to the incentives created by the change in value of the asset—the borrower could continue to service the loan but chooses not to. Default and foreclosure result because the borrower strategically chooses the option of foreclosure over the option of continued payment of the loan.”).


185. See Morgenson, supra note 1, (“In earlier years, actually being repaid by borrowers was crucial to lenders. Now, because so much consumer debt is packaged into securities and sold to investors, repayment of the loans takes on less importance to those lenders than the fees and charges generated when loans are made.”).

186. Alan M. White, Welfare Economics and Regulation of Small-Loan Credit: Lessons from Microcredit in Developing Nations, (Valparaiso Univ. Law Sch., Legal Studies Research Paper No. 10-12, 2010), available at http://ssrn.com/abstract=1711460 (“For the poor especially, credit can simply aggravate a bad cash flow situation, adding interest costs to an existing monthly shortfall. This can result in consumers being worse off than had they not borrowed. Overindebted consumers can be pushed into default and bankruptcy by repeated borrowing, even in small amounts, and suffer additional costs, such as the health effects of debt-related stress, and other social and external costs. Overindebtedness reduces welfare not only when borrowers default on their payments, but also when they resort to reducing consumption, selling assets or borrowing repeatedly to avoid payment default.”).
reconfigure the relationship between lenders and consumers. As Professors Barr et al. argue, in certain situations lenders profit the most when consumers are well informed, and thus have an incentive to educate their customers.187 But in many circumstances, lenders profit when consumers make choices that are against their best interests—thus giving lenders an incentive to amplify consumer confusion.188 Their paper, *Behaviorally Informed Financial Services Regulation*, contemplates various ways of addressing the problematic divergence between borrowers’ and lenders’ interests.

One way to tackle this problem is through the application of flexible disclosure standards instead of rigid rules.189 Rules that do not reach the context or manner of disclosure permit lenders to present disclosure documents to customers along with assurances that they are not important. By contrast, under a standards-based regime, courts could evaluate a lender’s disclosure after the fact to determine whether it “would have, under common understanding, effectively communicated the key terms of the mortgage to the typical borrower.”190 By applying a case-by-case standard, courts could be more sensitive to behavioral and contextual cues. This, in turn, could create an incentive for lenders to comply with the spirit, and not just the letter, of disclosure laws.

Barr et al. also discuss ways of eliminating brokers’ incentives to mislead borrowers by addressing structural features of the mortgage market that motivate brokers to sell loans that are not in consumers’ interests.191 The authors describe the need to regulate more than just disclosure in this context.192 Specifically, they propose a fundamental shift in the roles that brokers and mortgagers play: subjecting mortgage brokers to a higher standard of care.193 Professors McCoy and Engel flesh out this idea using the duty of suitability imposed on securities brokers as a model for requiring mortgage brokers to understand a consumer’s situation and offer a suitable loan.194

The arguments supporting the adoption of a more discerning judicial standard in lieu of rules to govern disclosure and a new fiduciary duty for brokers recognize that lenders must have incentives to actively inform and educate their consumers, or at least seek to minimize customer confusion and error. Unless lenders find that educating their borrowers actually serves their

188. Id.
189. Id. at 6–7.
190. Id. at 7.
191. Id. at 11–12.
192. Id. at 12 (“[B]rokers’ disclosures of potential conflicts of interest may paradoxically increase consumer trust. . . . Thus, if the broker is required to tell the borrower that the broker works for himself, not in the interest of the borrower, the borrower’s trust in the broker may increase: after all, the broker is being honest!”) (citation omitted).
193. Id.
194. Engel & McCoy, supra note 170.
own interests as well, it will be difficult to address the aforementioned problems: the lack of consumer awareness, proliferation of dangerous products, and the lenders’ incentive to mislead borrowers.

IV.
MAPPING THE NEW LANDSCAPE: POSSIBILITIES FOR CONSUMER FINANCIAL REGULATION UNDER THE “ABUSIVE” STANDARD

Congress designed the “abusive” standard amid concerns about market imperfections that lead to the creation and enforcement of credit contracts that reduce consumer welfare and redistribute wealth from the most vulnerable to the most stable members of society. This Part offers three possibilities for implementing the new standard to illustrate how it changes the landscape, in addition to highlighting some of the key tradeoffs that will have to be negotiated moving forward.

First, the “abusive” standard—and especially sections 5531(d)(1) and (d)(2)(A), which prohibit practices that materially interfere with a consumer’s understanding or take unreasonable advantage of a lack of understanding—could be used to improve the depth and breadth of consumer understanding. This is the least intrusive option currently on the table. In addition to working closely with groups like consumer advocates, industry representatives, academics, and policy analysts (which it has begun to do), the CFPB can also encourage lenders to experiment with new strategies to promote understanding, such as requiring consumers to interact with the information they are given beyond merely initialing each line. In tackling this project, the CFPB should consider the effect that simplifying disclosures could have on product design and weigh the value of complex financial products against their costs, including the risk that they will be targeted to the wrong market.

Additionally, the “abusive” standard could be used in extreme circumstances to limit the sale of inherently dangerous products or to impose penalties after the fact on lenders who have sold dangerous products. This category would be structured by section 5531(d)(2)(B), which prohibits taking unreasonable advantage of a consumer’s inability to protect his or her own interests, and could cover products that change suddenly and unexpectedly, are targeted at people who cannot afford them, or encourage their own misuse. Specifically, the practice of payday lending is one area that would benefit from more direct regulation. However, product regulation is a tool that will likely be used only sparingly by regulators, given the strength of pushback it is likely to encounter.¹⁹⁵

¹⁹⁵. See, e.g., Creating a Consumer Financial Protection Agency: A Cornerstone of America’s New Economic Foundation: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs, 111th Cong. 5 (2009) (statement of Sen. Richard C. Shelby) (“First, I believe that we must clearly acknowledge and accept that risk cannot be eliminated from our financial markets[.] It is risk
Pushing lenders to improve their customers’ understanding will have limited effect as long as lenders perceive this to run against their own interests. Thus, the final important piece of implementing the “abusive” standard is in section 5531(d)(2)(C), which prohibits lenders from taking unreasonable advantage of a borrower’s reasonable reliance on them. This provision restructures the relationship between borrowers and lenders so that lenders will benefit when borrowers are more informed. By imposing consequences for acting against consumers’ interests—for example by selling products that are expected to result in financial hardship—the provision should make lenders less likely to view a consumer sinking into debt as a cash machine. In response, lenders will likely alter other contractual terms to make up for any anticipated losses. Ideally, however, lenders will revise contracts to make the allocation of costs and risks clearer up front and to distribute burdens more widely instead of leaning hardest on their most vulnerable customers.

A. The “Abusive” Standard Could Be Used to Assess and Enhance Consumers’ Actual Understanding of Financial Products

Dodd-Frank includes a separate section immediately following the definition of abusive that is dedicated to disclosures, indicating that as a matter of statutory construction the new “abusive” standard goes beyond requiring mandatory disclosures.196 The separate disclosure section requires that “the features of any consumer financial product or service, both initially and over the term of the product or service, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances.”197 The section also provides for the development of “model disclosures” by the CFPB to serve as a safe harbor from enforcement so long as the disclosures use plain language, have a clear format, and are succinct.198 Finally, Dodd-Frank encourages lenders to conduct pilot programs in order to test new disclosures.199 Though the “abusive” standard goes beyond these provisions covering written disclosures, this section offers a useful framework for structuring the first two prongs of the “abusive” standard. For example, creating a safe harbor for lenders who adopt the most desirable

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199. 12 U.S.C. § 5532(e) ("The Bureau may permit a covered person to conduct a trial program that is limited in time and scope, subject to specified standards and procedures, for the purpose of providing trial disclosures to consumers that are designed to improve upon any model form issued pursuant to subsection (b)(1), or any other model form issued to implement an enumerated statute, as applicable.").
practices could encourage some of the practices that the CFPB does not have the power to mandate outright.

Professors Barr et al. describe several practices that could constitute a presumption of compliance with or a safe harbor under the “abusive” standard.\(^200\) First, they suggest that mortgage brokers disclose information beyond the details of a particular product, including the borrower’s credit score, a list of all of the lender’s products for which the borrower qualifies, and the prices at which lenders in general would be willing to lend to the borrower given his or her credit profile.\(^201\) A lender who honestly, clearly, and comprehensively describes the features of all the products for which a borrower qualifies should enjoy a presumption that it is not taking unreasonable advantage of a borrower’s lack of understanding, since this information should permit the borrower to pick the best option available.

The article also suggests imposing a requirement that was not incorporated in the final version of Dodd-Frank, namely the “plain vanilla” provision.\(^202\) Although the CFPB cannot require financial companies to provide safer products alongside those that incur more risk, it could still set standards for “safe” products and grant a safe harbor to lenders who consistently provide consumers with a standard option. Such a rule would not automatically impose liability on lenders who do not inform the consumers of such products, but could require them to show that their practices are not otherwise abusive.

In a similar vein, Jeff Sovern points out that disclosures are far more effective when borrowers must interact with them as opposed to merely reading them.\(^203\) For example, requiring a consumer to watch an informational video and answer questions about it, fill out a budgeting worksheet, copy out a disclosure by hand, or explain the product back to the lender could compel the borrower to take in the meaning of a given disclosure.\(^204\) The “abusive” standard could create a presumption of compliance with section 5531(d)(2)(A) for lenders who create mechanisms for consumers to meaningfully interact with disclosures in a way that advances their understanding.

Admittedly, a major challenge in applying this standard will be the assessment of consumer understanding, which is inherently internal and subjective.\(^205\) However, tools exist, including financial experience questionnaires that could determine which products would be most appropriate.

\(^200\) BARR ET AL., supra note 35.
\(^201\) Id. at 6.
\(^202\) Id. at 8–11.
\(^203\) Sovern, supra note 153, at 822–41.
\(^204\) Id. at 826–34.
\(^205\) This point raises many questions that are beyond the scope of this paper, including: who will assess consumer understanding—the government, lenders, courts, third parties? When will understanding be assessed—at the time of purchase or at the time of default? In general, without regard to a particular sale? Will understanding be assessed on a group level or an individual level?
for borrowers. The “abusive” standard could also incentivize lenders to develop new tools for assessing consumer understanding by creating a safe harbor for those lenders who do so.

B. The “Abusive” Standard Should Regulate Dangerous Products Including Payday Loans and Retroactively Distribute Harms and Benefits

Certain financial practices, like subsidizing rewards for well-off credit cardholders by charging high fees to those who struggle to meet their monthly bills, are unreachable under the “unfairness” standard because of its built-in balancing test. Yet where these practices do not permit consumers to protect their own interests, they may well fall within the “abusive” standard’s ambit. One of these practices is payday lending, an industry that has grown tremendously over the past twenty years to the detriment of many low-income borrowers. Although direct product regulation is a tool that policy makers should use judiciously, the payday lending industry is an obvious target for heightened regulatory control.

Payday loans vary from state to state but generally involve small-dollar principals, high fees, short terms for repayment, balloon payments, and the option of “rolling over” the loan—that is, renewing the loan by paying a new set of fees without gaining access to any additional capital. Payday loans are considered “fringe” products, despite the industry’s dramatic growth over the past twenty years, because they operate largely outside the mainstream banking system. Payday borrowers often turn to these loans because they are

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206. TREASURY DEPARTMENT WHITEPAPER, supra note 25, at 66 (“The CFPA should be authorized to use a variety of measures to help ensure alternative mortgages were obtained only by consumers who understood the risks and could manage them. For example, the CFPA could . . . require providers to have applicants fill out financial experience questionnaires . . . .”).

207. See id. at 27–28.

208. Much of this variation is due to the different regulatory schemes imposed on payday lending. Several states, like New York, have effectively banned payday lending by capping interest rates at 16 percent per year (which would yield $0.63 in fees on a two-week one-hundred-dollar loan). Ronald J. Mann & Jim Hawkins, Just Until Payday, 54 UCLA L. REV. 855, 879–80 (2007). Other states, such as Kansas and Michigan, permit payday lending but place certain limitations on it, for example by capping fees to a certain percentage of the principal, requiring that borrowers have a minimum of thirty days before the loan is due, capping fees on loan extensions, prohibiting “roll-over” loans, giving borrowers a window of several days during which they have the right to rescind the loan, and requiring lenders to post large signs in their stores informing borrowers of their rights. Id. at 874–77; Aimee A. Minnich, Rational Regulation of Payday Lending, 16 KAN. J. L. & PUB. POL’Y 84, 102–03 (2006).

209. See Mann & Hawkins, supra note 208, at 857–58.


unaware of other options, or because they do not qualify for more traditional loans due to their poor credit history or low income.

Payday loans are often justified as necessary evils. They are ostensibly intended for consumers with an urgent need for funds that they do not immediately have on hand, but to which they will shortly gain access. In a functioning marketplace populated by fully rational and informed individuals, one could expect borrowers to pay a premium for access to ready cash when necessary to prevent higher costs like defaulting on bills. Industry representatives take this view, arguing that when borrowers pay off these loans in full and on time, they are cheaper than the alternatives. For example, they posit that paying a high fee on a loan to cover a telephone bill is cheaper than having the phone line disconnected and paying the telephone company to reconnect it, or exceeding one’s credit card limit thus incurring an overdraft fee, or bouncing a check for a similar fee. However, this simple arithmetic ignores an underlying reality: “[C]onsumers who do not have $300 today are more profitable, larger loans, which had benefited from the deregulation of the banking industry and elimination of interest rate caps in the 1980s. The fringe-banking industry filled the vacuum by promoting alternative financial services to consumers with poor credit ratings or low to moderate incomes. Payday lending comprises an important part of the fringe-banking industry by issuing small loans to high-risk consumers who lack access to mainstream financial institutions.”; Mann & Hawkins, supra note 208, at 857 (“Payday lenders offer short-term loans at high interest rates to consumers with impaired credit histories.”); Minnich, supra note 208, at 84 (“Most of the products offer advances to consumers who are considered too high a credit risk for mainstream financial institutions.”).

212. See, e.g., The Payday Loan Reform Act of 2009: Hearing on H.R. 1214 Before the H. Comm. on Fin. Servs., 111th Cong. 15 (2009) (statement of Gerri Guzman, Resident, Montebello, California) (“Personally, I consider payday loans to be a necessary evil. If I had the choice, I would never have been in the situation where I needed a payday loan. I am sure this rings true for tens of millions of lending customers around the country. In a perfect world, we would all have the money set aside in a savings account to cover the expenses that are unexpected or unavoidable. But having much money in a savings account is not a reality for many working families, especially today.”).

213. An Internet provider of payday loans highlights the idea that these loans are short-term, stopgap measures, vaguely suggesting that most customers pay them back in two weeks, even though this is not the case. See MYPAYDAYLOAN, http://www.mypaydayloan.com (last visited June 10, 2012) (“[P]ayday loans are short-term cash advances designed to meet your financial needs when you’re in an emergency situation. . . . [P]ayday loans are perfect for times when you need a little extra cash for unexpected bills or special occasions. The fee for advancing a payday loan is $25 per every $100 borrowed. Payday loans are generally paid back on your next payday however, you can extend the loan by making the minimum payment on the cash advance.”).

214. The Payday Loan Reform Act of 2009: Hearing on H.R. 1214 Before the H. Comm. On Fin. Servs., 111th Cong. 3–4 (2009) (statement of Rep. Hensarling) (“Again, if we pass this legislation, I believe that consumers are going to be forced into many alternatives that they may find more harmful to them. The average telephone reconnect fee is $50, maybe many consumers would have preferred to pay the $15 market fee to borrow the hundred. The average cable reconnect fee can be as much as $100. Again, there are many consumers who would prefer to pay the $15 than the $100 reconnect fee. A bounced check can average $28.23. Overdraft fees can be $56. Now, if we get focused on APR, which may or may not be the best way to judge these loans, a bounced check can have an APR of 755 percent, and you add the overdraft fees. All of a sudden on that same $100 loan, you are at 1,449 percent.”).
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unlikely to have $345 in two weeks.”215 In short, for many, payday lending is a gateway into a cycle of increasing indebtedness.

Little research supports the assumptions that people who take out payday loans do so because their only other alternative is to default on their financial obligations.216 Moreover, this assumption ignores the possibility that lending institutions could provide necessary products that are slightly less harmful—for example, small loans that could be repaid in installments and could not be rolled over.

Arguments in favor of payday lending tend to ignore the net impacts of short-term, high-cost loans on overall consumer welfare. There is little discussion of what is driving the underlying demand for such loans or how the purpose of a loan might be correlated with a borrower’s ability to pay it back. In public discourse these loans are often justified by their alleged usefulness during an emergency such as a car breaking down or the power shutting off. For example, in an April 2009 hearing on the Payday Loan Reform Act, Representative Hensarling shared letters he had received from his constituents in support of payday lending:

I also heard from Paul in Mesquite, Texas: “Working payday to payday in this economy we sometimes need a quick loan for food, gas, utilities, prescriptions. If payday loans are banned, our checks may have to bounce and then I have to pay the big banks overdraft charges. I won’t name the name of the company. Payday lenders are helping working Americans stay afloat ’til payday.”217

By arguing that payday loans are the only option for people struggling to get by, Representative Hensarling fails to consider whether people in such dire economic straits will find themselves worse off in the long run by taking on debt—especially when the debt is not a means of advancing or even achieving some sort of stability, but is incurred simply to forestall short-term crisis.218


216. See Angela Littwin, Testing the Substitution Hypothesis: Would Credit Card Regulations Force Low-Income Borrowers into Less Desirable Lending Alternatives?, 2009 U. ILL. L. REV. 403, 403 (2009) (finding that there is a lack of research on the elasticity of demand for credit and the tendency of borrowers to substitute one form of borrowing for another “but the substitution hypothesis is more frequently assumed than investigated, and prior empirical research does not support the theory as strongly as has been supposed. The theory is based on a naïve presumption about the constancy of demand for consumer credit and fails to account for a more nuanced view of the role of credit supply.”).

217. T h e P a y d a y L o a n R e f o r m A c t : H e a r i n g o n H . R . 1 2 1 4 B e f o r e t h e S u b c o m m . o n F i n . I n s t . a n d C o n s u m e r C r e d i t o f t h e H . C o m m . o n F i n . S e r v s . , 1 1 1 t h C o n g . 8 ( 2 0 0 9 ) .

218. Alan White points out that the human development framework in which microcredit developed is not part of the conversation about small-value loans to low-income borrowers in this country, and that by comparing the two models we may be able to design a more welfare-enhancing credit market. White, s u p r a n o t e 1 8 6 .
Hard data reveal that payday lending in practice does not conform to its stated purpose. Instead of using such loans as an occasional stopgap in the face of a monthly shortfall, the majority of payday loan customers get “stuck” in a cycle of debt from which they cannot escape. The Center for Responsible Lending (CRL) found that in 2004, 91 percent of payday loan revenue was earned from customers taking out five or more loans per year.\textsuperscript{219} In fact, two-thirds of payday loan customers take out five or more loans a year, and nearly one-third take out twelve or more, bumping the average number of loans obtained per year to between eight and thirteen.\textsuperscript{220} CRL estimated that five million people are trapped in this debt cycle each year.\textsuperscript{221}

Disclosure regulations are unlikely to address the underlying problems surrounding payday lending. Many payday lenders disclose their terms conspicuously at the point of sale,\textsuperscript{222} and studies suggest that additional warnings provided to payday borrowers would have a limited effect on borrowing behavior.\textsuperscript{223} In general, borrowers understand that they will have to pay a high fee in exchange for a short-term loan. However, consumers are often unable to accurately predict whether they will be able to pay the loan back. Further, borrowers are frequently unaware of less expensive alternatives, under the mistaken impression that they are ineligible for those alternatives, or are actually ineligible for those alternatives. It is unlikely that the “deceptive” or “unfair” standards could substantially reform the payday lending practice. The balancing test embedded in the “unfairness” standard makes it hard to counter the “necessary evil” argument: if a product is framed in the context of the horrible parade of worst-case alternatives, regulators will be hard pressed to find that its slim benefits do not make it nonetheless worthwhile.

Thus, the “abusive” standard has a role to play in regulating—or perhaps even banning—payday loans. These loans take advantage of consumers’ inability to protect their own interests\textsuperscript{224} because they are designed so that the average consumer cannot use them as intended. They are not, effectively, short-

\textsuperscript{219} Ernst et al., \textit{supra} note 210, at 2.
\textsuperscript{220} \textit{Id.}
\textsuperscript{221} \textit{Id.}
\textsuperscript{222} For example, in 2007 the Community Financial Services Association of America (CFSA) passed a rule requiring its members to post their fees on eighteen-by-twenty-two-inch posters in their stores. See \textit{Payday Lending Industry Announces Unprecedented Fee Disclosure Policy}, VLEX (Nov. 15, 2007), http://newswire.vlex.com/vid/payday-lending-unprecedented-disclosure-193339539.
\textsuperscript{223} See Marianne Bertrand & Adair Morse, \textit{Information Disclosure, Cognitive Biases and Payday Borrowing} 35 (Univ. of Chi. Booth Sch. of Bus., The Initiative on Global Mkts., Paper No. 4, 2010), \textit{available at} http://ssrn.com/abstract=1532213 (“Our results also show, however, that the power of information disclosure, or at least the specific forms of information disclosure we experiment with in this paper, may be limited for some groups of payday borrowers. Most important from a policy perspective is that we find no response to the disclosure among individuals that take up large payday loans (as a fraction of their income). This suggests that information disclosure might be a more effective policy tool if it is also combined with well thought-out regulatory limits on how much people can borrow at such high interest rates relative to their payback capacity.”).
term loans, but rather disguised long-term loans that allow lenders to harvest a steady stream of fees from very small amounts of capital. Payday loans could thus be classified as abusive because they are designed to fail their target market and the requirements of the CFPB.

C. The “Abusive” Standard Could Impose Affirmative Duties on Lenders to Refrain from Intentionally Acting Against Consumers’ Interests

Lenders will have scant reason to dedicate their ingenuity to the task of educating consumers unless they perceive that the effort aligns with their long-term interests. To address this, section 5531(d)(2)(C) imposes responsibility on lenders not to act against consumers’ interests, and perhaps even to actively work in favor of these interests. In theory, this provision could bar lenders from selling products that consumers cannot reasonably be expected to afford or products likely to lead to severe forfeitures. A more conservative approach would be to use section 5531(d)(2)(C) to develop an ex post standard in litigation to penalize instances where a lender breached a consumer’s trust in some way short of deception or material misrepresentation. A liability rule of this sort would give lenders an incentive to understand and endeavor to meet their borrowers’ needs. The following Subsection explores the possibilities for imposing duties on lenders in the context of the credit card market and the mortgage lending industry.

1. Considering the Interests of Credit Card Applicants

Credit card companies extend unsecured credit to a high volume of consumers based on fairly minimal information. Credit card applications generally do not involve face-to-face interactions, long-term relationships, or detailed discussions of a card applicant’s financial plans. However, even in the context of relatively impersonal transactions, consumers may rely on credit card companies not to lend to them if they are a high credit risk. What these customers do not realize is that card companies actually target the customers that they expect will go into debt and rack up high fees.

Angela Littwin conducted interviews with low-income women about their experiences using credit cards, providing a telling window into the features that make credit cards particularly dangerous and instructive feedback regarding the steps companies could take to better suit these products to consumers’ needs.225

A common problem that many participants cited was the barrage of credit card offers that they received in the mail on a near-daily basis.226 Although all the women interviewed lived in public or Section 8 housing, over 90 percent reported that they received credit card offers on a regular basis.227 This

225. Littwin, supra note 173.
226. Id. at 475.
227. Id.
inundation of offers suggests that credit card companies are either specifically targeting low-income families or are sending out offers regardless of consumers’ income levels. On the one hand, these statistics simply fit an overall increase in access to credit. However, a quarter of the group reported they had to tear up the offers without opening them to avoid the temptation to apply for more credit. This behavior dramatizes the internal struggle that many consumers feel when confronted with financial products.

While these cardholders wanted to maintain access to credit, especially for emergency use, they also wanted ways to “precommit” to certain spending levels or patterns to avoid falling into high levels of debt. Precommitment devices include allowing consumers to opt out of receiving credit card solicitations by mail, allowing consumers to cap their credit limits, requiring the credit card companies to seek consent before raising credit limits, converting credit limits into actual limits on what cardholders can charge (as opposed to threshold above which credit becomes more expensive), and allowing consumers to block their card from working at certain stores or during certain time periods.

Some of these precommitment options already exist. For example, the Consumer Credit Reporting Reform Act of 1996 made it possible for consumers to opt out of receiving prescreened offers. Prescreened offers are especially problematic because they make it easier for consumers to obtain more credit than they should take on, and sends a message that a credit card is tailored to their needs. Consumers may rely on this message to their detriment when deciding whether or not to obtain the card.

The “abusive” standard could take existing regulation a step further by requiring credit card companies, before sending an offer, to make an initial determination that the recipient can reasonably afford the product based on, for example, income, current debt level, and credit history. In addition, it could require that such offers be accompanied by information about how the recipient’s creditworthiness has been evaluated so that the customer can make a better assessment of whether this product is appropriate.

In order to control their credit limits, some participants in the credit card study reported purposefully selecting cards with low limits to cap their spending in advance. Others attempted to limit increases on their credit limits to no avail. When one participant, who earned $25,000 per year, asked her...
credit card company to cap her credit limit at $10,000, the company refused to do so. In cases like these where consumers feel uncomfortable with the amount of credit they have been granted, companies should be required to reduce consumers’ potential to incur debt by, for example, responding to consumer requests to lower credit limits.

The fact remains that many customers reasonably believe that their credit limit reflects the amount of money credit card companies expect they can borrow in a given month and pay back in a reasonable amount of time. In reality, this is not the case. If consumers better understood how credit limits are calculated, the risk of using a card with a limit designed to encourage unaffordable spending would likely decrease.

2. Mortgage Lenders Should Be Subject to a Duty of Suitability

While credit card offers are distributed on a broad, impersonal basis, obtaining a mortgage is a more time-intensive and personal transaction. Applicants meet with loan originators to discuss the loans for which they qualify and the details of their finances. Although consumers may believe that mortgage brokers are working for them with the goal of providing the best available loan, brokers often have incentives to sell a more expensive loan, irrespective of the consumer’s ability to afford it. Section 5531(d)(2)(C) allows the CFPB to restructure the relationship between mortgage brokers and borrowers so that brokers find it in their best interests to originate only those loans that are appropriate to a consumer’s needs. The “abusive” standard is thus the perfect vehicle for imposing a duty of suitability on mortgage brokers to ensure that borrowers’ interests are not afterthoughts in the lending process.

In the realm of securities, the duty of suitability requires dealers to take into account a buyer’s risk profile and other preferences when selling securities, and makes them liable for selling “unsuitable” products. HOEPA applies similar duties in the sphere of mortgage lending, prohibiting lenders from making high-cost loans without taking into account borrowers’ ability to repay them.

236. Id. at 476–77.
237. See BARR ET AL., supra note 35, at 11–12. The National Association of Mortgage Brokers responds to some of these charges on its website, asserting that consumers are in the best position to know which loans are right for them and that competition prevents brokers from “steering” consumers to the most expensive loans. Frequently Asked Questions, NAMB: THE NAT’L ASS’N OF MORTG. BROKERS, http://www.namb.org/namb/FAQs1.asp (last visited June 10, 2012).
238. FIN. INDUS. REGULATORY AUTH., FINRA MANUAL § 2310 (1996) (“(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.”).
239. See, e.g., 12 C.F.R. § 226.35(b)(1) (2012) (“Repayment ability. A creditor shall not extend credit based on the value of the consumer’s collateral without regard to the consumer’s repayment ability as of consummation as provided in § 226.34(a)(4).”).

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Professors McCoy and Engel lay out a detailed plan for transposing the duty of suitability from the securities to the mortgage context. First, they posit that the reasons for imposing a suitability requirement in the securities market apply equally to the subprime mortgage market: mortgage brokers are often in the best position to prevent harm to consumers, disclosure has not been a very effective tool in helping borrowers select loans, and consumers are prone to trust mortgage brokers because of their superior financial knowledge. The professors also discuss the difficult balancing act between standards and rules, observing that the uncertainty of a standard could cause cautious lenders to abandon the subprime market entirely, while the specificity of rules make them easier to work around. McCoy and Engel resolve this in part by proposing a duty similar to that required by HOEPA, which disallows asset-based lending, loan-flipping, and selling subprime loans to borrowers who qualify for prime rates. In addition, they suggest that vesting rulemaking authority in a federal agency would provide clarity while allowing the regulations to evolve and providing a forum for outside input.

CONCLUSION

There are three broad and interconnected sources of failure in the consumer financial market. First, poorly informed consumers are drawn to products that are designed to appeal to common cognitive and perceptual errors, as opposed to products that would better match their individual spending needs and behaviors. Second, since consumers are drawn to products that have hidden negative consequences, lenders find it profitable to provide ever more-alluring products that incur increasing costs down the line. Finally, consumers who rely on sellers to help them identify suitable products may be led astray by lenders who have divergent incentives.

Meanwhile, the background legal regime of disclosure does not go far enough to help consumers make beneficial choices. Existing consumer protection standards do not require lenders to ensure that their customers understand the risks they are assuming, and these standards cannot prevent lenders from targeting individuals who are desirable customers precisely because of their financial instability. The common law of contracts, grounded as it is in the model of the perfectly rational and informed consumer, does not come anywhere near resolving these problems.

The new “abusive” standard could first address these related problems by enhancing consumer understanding. Instead of encouraging information dumping through disclosure rules, it can start to account for the way that

240. Engel & McCoy, supra note 170, at 1334–57.
241. Id. at 1334–36.
242. Id. at 1342–44.
243. Id. at 1343–44.
244. Id. at 1345–46.
consumers actually make sense of financial information in order to provide key pieces of information in a way that will be more useful. Agreements that run many pages, use heavily technical “legalese,” make frequent references to terms like “LIBOR” with which many consumers are unfamiliar, and are printed in hard-to-read type will likely be deemed abusive on the grounds that they “materially interfere[] with the ability of a consumer to understand a term or condition” or “take[] unreasonable advantage of . . . a lack of understanding on the part of the consumer.” Thus, the “abusive” standard will encourage lenders to make information accessible, digestible, and useful.

Added to the challenges of understanding a given product, the difficulty of anticipating the risks that might impact one’s financial stability is no match for the massive models that credit companies construct. This imbalance renders consumers particularly vulnerable to lenders who design or market products tailored to their weaknesses or to risks the consumer has not yet detected. Thus, the “abusive” standard could also provide a way of identifying and limiting the availability of financial products, such as payday loans, that are harmful and incapable of being used safely.

Finally, the “abusive” standard could explicitly require lenders to consider consumers’ interests. This could, for example, remove lenders’ incentives to advise consumers that products are suited to them without disclosing that the customers qualify for cheaper offerings.

If all these pieces come together, then the “abusive” standard can help shift lenders’ business models so that they do not target low-income customers with unaffordable products, but instead find ways of extending credit so as to enhance consumer welfare and contribute to upward mobility.

245. London Interbank Offered Rate.