
RESPONSE

UNSAFE AT ANY PRICE?

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In response to Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008).

INTRODUCTION

*Making Credit Safer*¹ is a fascinating collaboration between two scholars of very different bents. Elizabeth Warren's career rests on decades of careful empirical research, integrated into trenchant policy analysis, and deeply informed by the cultural and social significance of debt. Oren Bar-Gill, by contrast, is a formally trained economist, who is at the start of his academic career, and has gained wide recognition for his successful application of theories of behavioral economics to the products that dominate the modern credit card industry.

The article's central thesis is difficult to rebut: that the markets for consumer credit products operate so poorly that government intervention is appropriate.² The existing regulatory system focuses almost entirely on the soundness of the financial institutions that provide the products; there is no agency charged with protecting the interests of consumers. The article supports the thesis with a comprehensive canvassing of the behavioral economics literature. Thus, it buttresses and expands Bar-Gill's earlier writing on the subject, in

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¹ Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008).

² See *id.* at 98-100 (proposing the creation of a Financial Products Safety Commission with broad authority to regulate consumer credit products).

which he argues that market pressures force credit card lenders to design products that take advantage of the hyperbolic discounting tendencies of typical consumers.³ This suggests, although the authors do not single out credit cards for separate regulatory treatment, a particular need for intervention in the credit card market. Because the products that are most profitable (at least in some segments of the industry) are those that most successfully take advantage of cognitive limitations of consumers,⁴ the interests in soundness and in consumer protection are in that context directly opposed.

As with most of the behavioral economics literature, the discussion is short on data. The existing data rest largely on experiments that are sufficiently removed from typical market transactions so as to justify skepticism about their probative force. Still, the close match between the cognitive failures that behavioral theorists predict and the products that dominate the credit card market makes it hard to believe that issuers are not at least unconsciously designing products that exploit those tendencies.⁵

But the authors do much less to support the link between the imperfection of consumer credit markets and the policy response of a government agency with a broad and general mandate to eliminate “unsafe” products. There are, of course, a variety of responses that policymakers could take, ranging from governmental definition of the products to be offered, to ex ante proscription of offensive product attributes, to ex post remedies that might limit the enforceability of offensive products or provide compensatory or punitive relief to consumers.

My principal concern with the article arises from the likelihood that a federal agency with a general mandate focused on “safety” will not, in the long run, effectively advance the interests of consumers. The authors write on the eve of the inauguration of a Democratic President, who will confront a legislature controlled by Democrats, with a public mandate to reinvigorate the economy while enacting institutional reforms designed to prevent future financial crises of this sort. It is easy to assume that any such agency will move aggressively to protect consumers. But the problems the authors address are not

³ See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1395-1408 (2004).

⁴ See *id.* at 1401-08.

⁵ See Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505 (2006) (explaining how the rational behavior of customers works against the intuition that companies that hide or “shroud” hidden costs should eventually be harmed by the practice).

simple, and they will not disappear overnight. Ultimately, the vagueness of the mandate that they propose increases the chance of a variety of unsatisfactory outcomes. The agency might err in responding to the problem, and a vague statutory mandate would for the most part insulate even an ineffective response from review.

For example, although the Federal Reserve implemented the disclosure requirements in the Truth in Lending Act⁶ sympathetically,⁷ most would agree that the resulting disclosures were so poorly prepared that they were more likely to confuse consumers and obscure salient product attributes than they were to lead to informed decision making.⁸ It took decades for the Federal Reserve to respond with a more nuanced set of disclosures built on investigation into the actual responses of consumers.⁹ More seriously, traditional problems like regulatory capture and policy drift might lead the agency over time to provide considerably less protection for consumers than Congress might contemplate when passing the statute.¹⁰ Again, given the public-choice difficulties of making a substantial shift in the mandate of an existing agency, the time for specificity in direction is when the agency is established, not years later after it has been captured.

Responding to that concern, the remainder of this brief Response addresses two problems that complicate determination of the appropriate response to the market imperfections that the authors identify: the problem of specifying what it means for a financial product to be “unsafe”; and whether the “safety” of the products is as important a

⁶ 15 U.S.C. §§ 1601-67 (2006). The Act is administered by the Federal Reserve Board under an interpretive regulation popularly called “Regulation Z.” Truth in Lending (Regulation Z), 12 C.F.R. § 226 (2008).

⁷ See, e.g., Jonathan M. Landers & Ralph J. Rohner, *A Functional Analysis of Truth in Lending*, 26 UCLA L. REV. 711, 713-15 (1979) (describing, and then criticizing, the basic consumer-informational intentions that motivated the Truth in Lending Act).

⁸ See, e.g., RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 134-36, 159-60 (2006) (describing the factors that prevent a typical consumer from fully responding to required disclosures and the problems caused by the Truth in Lending Act’s disclosure requirements).

⁹ Truth in Lending, 72 Fed. Reg. 32,948 (June 14, 2007) (to be codified at 12 C.F.R. pt. 226)).

¹⁰ See generally, Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089 (1991) (suggesting a model of congressional oversight of regulatory agencies designed to prevent the capture of those agencies by industry or consumer interest groups); Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. (SPECIAL ISSUE) 167 (1990) (proposing a middle ground between the conflicting “public interest” and “agency capture” models of regulatory behavior).

concern as the secondary effects that market imperfections have on patterns of household borrowing and wealth accumulation.

I. CREDIT CARDS AND TOASTERS

The authors return throughout their discussion to the compelling analogy of a toaster: when we buy a toaster at a store, we don't have to worry that it will catch fire, electrocute our children, or crumble into obsolescence in the first month after we buy it.¹¹ Whatever force market pressures and information intermediaries like *Consumer Reports* might bring to bear for products on the margin,¹² the government has directly identified and removed from the market the most obviously defective products.¹³ As the authors document, the market alone would produce a substantial number of objectively "unsafe" products; the unqualified mandate to ensure consumer "safety" has been adequate to force the removal from the market of a large number of products.¹⁴ Few can doubt that the Consumer Product Safety Act has saved many lives and prevented a great deal of injury and loss. If the market for consumer financial products works even more poorly than the market for toasters, why shouldn't a similar statutory mandate be applied here?

On reflection, however, the analogy is much more problematic than it seems at first glance. The basic problem lies in operationalizing the concept of "safety" for financial products. Although there are close cases on the margin, the concept of safety is easy to identify for many tangible consumer goods. While the optimal number of consumers electrocuted by faulty wiring on a toaster might not be zero, it is very close to it, and the social losses from banning toasters that have an identifiable risk of electrocuting consumers in ordinary use are sufficiently slight such that policymakers cannot be faulted for ignoring them. Similarly, few will worry about a regulatory mandate that deprives consumers of the option to buy a lawnmower without a guard that prevents the user from slicing off toes and feet.

¹¹ See Bar-Gill & Warren, *supra* note 1, at 8-10.

¹² *Id.* at 15-17.

¹³ *Id.* at 9-10.

¹⁴ See *id.* at 4 ("Nearly every product sold in America has passed basic safety regulations well in advance of being stocked on store shelves.").

II. SAFETY AS THE ABSENCE OF RISK

For financial products, however, the question of safety is much more problematic. At first, looking to the toaster analogy on which the authors rely, we might think that the simplest way to define the “safety” of a financial product relates to the ability to repay: financial products are unsafe if they involve an “undue” risk that consumers will not be able to meet their obligations.¹⁵ But it is difficult to know what risks would be “undue.” It is plain that the optimal level of default on consumer loans is substantially above zero: if credit seems tight after the crisis of 2008, imagine how little lending we would have if banks could make loans only when they could be absolutely sure that all borrowers would repay. As a simple matter of economics, it is easy to see that consumer lending (like commercial lending) generates a great deal of positive spillover effects. Consumer borrowing generally facilitates fruitful economic activity. At the simplest level, it helps to generate the spending on which economic growth and stability depend. At a larger level, a considerable amount of borrowing that is formally “consumer” lending is used for investment in business or innovation, activities that have obvious benefits to the community in which the investments are made. Further, consumer lending has evolved to the point that it is no longer closely associated with income, wealth, or class-based differences: substantially all members of our society can borrow money, at some price. This has income-generating effects if it allows a member of the nonworking poor to purchase clothes for a job, and has wealth-generating effects if it allows a poor household to acquire a home. If we truncate borrowing to the point where default is nonexistent (or even rare), the gains from eliminating the cases of financial distress might dwarf the losses from economic activity foregone from the decline in the availability of funds.

From a more libertarian perspective, it is easy to agree as a society to deprive consumers of the choice to buy shoddy and dangerous consumer products—we give little weight to the constraint imposed on

¹⁵ At one time, usury limits would have provided a rough limit of this sort, because they would restrict the ability of issuers to profit from loan transactions in which a stated rate of return would be inadequate compensation for the risk of nonpayment. The demise of interest-rate limitations in the consumer finance industry removes that possibility. See generally Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518 (2004) (examining the decreased importance of state usury laws due to federal regulation and the development of the “Exportation Doctrine,” which allows lenders to strategically protect themselves with state laws with the least restrictive consumer credit regulations).

the consumer who might claim a sincere desire to buy the electrocuting toaster. By contrast, it is much harder to agree that consumers should not have the ability to accept a “risky” loan. In part, this might rest on the intuition that consumers purchase the electrocuting toaster only because of errors. If all purchases are erroneous, in the sense that no fully informed consumer would wish to purchase the toaster, then the constraint of preventing that choice might be value-increasing for all involved. For credit, by contrast, rational consumers well might wish to accept risky loans. Imagine, for example, the consumer faced with a catastrophic medical event, the treatment for which is not covered by available insurance. It often would be rational from the consumer’s perspective to accept a loan to pay for the treatment. And given the likelihood of positive spillover effects from the consumer’s return to health, it might even be a socially beneficial choice, even if the likelihood of default on the loan is quite high.

III. SAFETY AS THE ABSENCE OF MANIPULATION

Another possibility, building on the analysis of behavioral effects that dominates *Making Credit Safer*, is that products are unsafe if they involve an “undue” level of manipulation of the behavioral and cognitive limitations of those who use the products.¹⁶ The basic idea here is that when consumers use financial products *because of* behavioral manipulation by those who design and market the products, it is responsible for a regulatory authority to set aside their choice (if already made) or prevent the choice altogether, by excluding the manipulative product from the market completely.

Although this approach seems much more promising, it is not clear that it is any easier to implement than the concern about risk discussed above. For one thing, it is undermined by the lack of data about the ways product design affects use. It is one thing to say, as the authors do, that the design of modern credit card products mirrors so closely the most notable types of cognitive limitations identified in the literature on behavioral economics that we can accept the notion that the products are designed by reference to those limitations.¹⁷ It is quite another to say that all, or even most, of those that use those products do so *because of* those product attributes.

¹⁶ See Bar-Gill & Warren, *supra* note 1, Part I.B.3.a.

¹⁷ *Id.* at 46 (“In many cases, [credit card] sellers design their products to exploit consumers’ imperfect information and imperfect rationality.”).

For example, consider the teaser rate. It surely is the case that many of the people that select particular mortgage and credit card products because of low introductory rates do so with an inadequate appreciation of the likelihood that they will pay higher rates when the teaser rate expires. But it is just as surely the case that many people who select those products successfully take advantage of the teaser rates and repay their indebtedness without ever suffering the higher back-end rates. So a ban of this product cannot be justified simply by reference to the weak reasoning of those who use it. Rather, it has to be justified by some notion of behavioral neutrality: the market would be better in some notable way if products were stripped of their manipulative attributes and left to compete against each other on “neutral” terms. But who is to decide when products are behaviorally neutral? The trendy promise of “libertarian paternalism” notwithstanding,¹⁸ the absence of a baseline of behavioral neutrality is a powerful obstacle to policy reforms based on behavioral intuitions.

It is one thing to talk about rearranging food on a cafeteria line,¹⁹ but when regulators set about the task of banning products based on behavioral manipulation they face the much more difficult task of determining what types of products will and will not be permitted. If the behavioral-economics literature has demonstrated anything, it is the regularity and predictability of behavioral responses, underscoring the difficulty that confronts traditional regulatory strategies.²⁰ For example, it demonstrates the weakness of disclosure as a useful tool of consumer regulation. Effective regulation in this area inevitably will have a substantial effect on the product choices available to consumers, and inevitably will limit the ability of consumers to use products that often

¹⁸ See RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 4-6 (2008) (introducing the term “libertarian paternalism,” or the practice of public and private institutions “nudging” people to make good decisions without depriving them of the ability to choose freely); see also Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for “Asymmetric Paternalism”*, 151 U. PA. L. REV. 1211 (2003) (promoting a regulatory approach of “asymmetric paternalism,” defined as regulation which creates substantial benefits for those who make erroneous decisions and imposes little or no harm on those who make rational choices).

¹⁹ See THALER & SUNSTEIN, *supra* note 18, at 1-3.

²⁰ See generally DAN ARIELY, *PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS* (2008) (demonstrating how behavioral economics can “predict” the irrational decisions that people frequently make). There also is the related difficulty that even the free-market strategies that Thaler and Sunstein advocate are likely to have unintended consequences. Thus, a regulator attempting to calibrate an appropriate action must weigh the risks of inadequate response with respect to the targeted deficiency against a potential increase in the scope of unintended consequences.

would benefit them. The example of the teaser rate—often used for both good and bad reasons—shows just how difficult a choice that would be. The decision needs to be made based on a critical and informed assessment of the effects of the product and its absence, not a blithe assertion that the product succeeds because it is manipulative. The most that the literature establishes to date is that regulators should think carefully about the psychology of decision making as they consider how to regulate consumer financial products. The Federal Reserve’s recent disclosure rules display a commendable interest in this subject. But much more work needs to be done before regulators can make informed decisions about the appropriate balance between complexity and flexibility in the design of financial products. Given the difficulty of the task, there is reason to doubt how much reasonably can be accomplished by a federal agency implementing an unspecified mandate to promote “safety.” This is not to say that efforts to simplify products and remove their heavily behavioral attributes would be bad. It is to say, however, that it may be harder than it seems.

IV. THE TAIL AND THE DOG

For the most part, however, the difficulty of defining the “safety” of financial products obscures a more fundamental concern with the proposal. The focus on the terms of those products is understandable. As the authors demonstrate, the products are fiendishly complex. There is no reasonable likelihood that the consumers that use them understand them well. Many of the most complex terms—double-cycle billing, minimum interest charges, universal default rules—impose heavy, unexpected costs on consumers, in times when the consumers are most in need. But without denying the reality of that problem, I do not think it is the most important problem related to consumer financial products. For one thing, the complex provisions in the aggregate provide a rough benefit to the efficiency of the product by shifting a greater share of the costs to the customers that pose more risk. Because riskier customers are more costly users of the product, pricing designs that shift a greater share of costs to those customers have at least the possibility of being appropriate uses of price discrimination.

To be sure, we would be more ready to accept the pricing structure if we thought that consumers understood the pricing structure well enough for customer choice to drive the structure to an optimal outcome. But the most that can be said about the problem is that

competitive pressures distort the price structure by giving an excessive return to complex or back-loaded price structures. Some might think that the reason Capital One is so persistently successful in this market is because it has done such an excellent job of integrating these insights into its products.²¹ There is much less reason to think that competition is inadequate to lower the aggregate level of revenues.²² Although the large profits the most successful credit card issuers have made in recent years are provocative, the truth is that the industry as a whole is fiercely competitive.

The issuers that have made prudent product choices and invested adequately in the technology required for effective product design have been highly profitable and thus have steadily driven from the field the large mass of relatively incapable (and considerably less profitable) issuers. Thus, by the end of 2007, the five largest credit card issuers (Bank of America, JPMorgan Chase, CitiBank, Capital One, and HSBC) held 77% of all credit card debt in the United States. If we account for the recent acquisition of Washington Mutual by JPMorgan Chase, those issuers now originate more than 80% of all outstanding credit card receivables in the United States.²³ It may be that market concentration in the future will lead to supranormal profits. But that fear seems remote at a time when three of the top six issuers as of the end of 2007 (Bank of America, CitiBank, and Washington Mutual) lost money during the most recent quarter.²⁴

The long-term problem of much deeper concern is the relation between those products and spending. As the authors well understand, the most important social problem related to consumer financial products, and especially to credit cards, is the likelihood that they facilitate unreflective spending and subsequent financial distress. It is one thing for a considered risk to lead to financial distress and failure. As a matter of social policy, it is quite another when the spending and

²¹ See THOMAS H. DAVENPORT & JEANNE G. HARRIS, *COMPETING ON ANALYTICS: THE NEW SCIENCE OF WINNING* 41-42 (2007) (holding up Capital One as a salient example of the successful integration of data analysis with product design).

²² Bar-Gill recognizes this in his prior work. See Bar-Gill, *supra* note 3, at 1387-88.

²³ *Top U.S. Visa/Mastercard Credit Card Issuers*, NILSON REPORT, Issue 895, Jan. 2008, at 9.

²⁴ Conversely, the likelihood that the more capable issuers will continue to earn positive returns, even during a serious recession, underscores the strength of a business model in which the predictable cognitive failings discussed in *Making Credit Safer* can help issuers acquire customers who will rapidly incur debts that they cannot hope to repay for many years. See Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 384-92 (discussing the business model of debt-based credit card issuers in detail).

borrowing are unreflective, or even accidental. The psychological literature, much of it discussed in *Making Credit Safer*, underscores the close relation between hyperbolic discounting and precisely this type of unreflective consumer spending.²⁵ Although the precise causal relationship is difficult to untangle, few would doubt that consumer financial products, especially credit cards, provide a crucial link in that process.

Alteration of the fee structures and related terms for card products will have little or no effect on that problem. By hypothesis, the reason that those fees are troubling is that consumers are so unaware of them that they do not “price” them when they decide to use the cards. If that is so, then changes in the terms that impose those fees will have little or no effect on the way in which consumers perceive the cards. If anything, it will have the perverse effect of making credit cards *more* attractive.

In the end, then, I worry that a focus on “safety” will lead regulators in the wrong direction. In my view, however troubling the contract terms that dominate current legislative discourse may be, it is much more important to focus on reforms that will respond to the culture of unreflective borrowing and consumption. That is not to suggest that those problems are any easier to solve than the problem the authors tackle. In the midst of a recession that has devastated consumer confidence, policies to limit consumer borrowing and spending will not be near the top of the agenda. But, however difficult it might seem to confront those issues in the present climate, they are the issues of long-run importance.

CONCLUSION

I heartily agree with the authors that it would be beneficial for Congress to charge some component of the federal government with oversight of the problems arising out of credit cards in particular and consumer credit more generally. My concern is that the agency is likely to do a better job if more of the analytical issues are addressed before turning the issue over to the political process.

I do not disagree with the aptness of the metaphor and imagery of “safety.” Yet this metaphor raises the question as to why product safety is not within the institutional competence of the Federal Trade Com-

²⁵ See STUART VYSE, *GOING BROKE: WHY AMERICANS CAN'T HOLD ON TO THEIR MONEY* (2008).

mission (FTC). The FTC should be well-situated to apply existing regulatory strategies to a new context. But, I believe the focus on product “safety” obscures the more fundamental question whether an entity is needed to protect consumers from using the financial products improperly.

We all would benefit from more careful governmental attention to the contributions of credit cards to overindebtedness and related social problems. Careful assessment of those problems, in turn, could lead to policy reforms that would address the underlying issues more directly.²⁶

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²⁶ See, e.g., MANN, *supra* note 8, at 193-96 (contending that a marked increase in the minimum monthly payments permitted on credit cards would limit the adverse effects of the “sweat box” model of credit card lending).