Federal Trade Commission

Managing Irrationality: Some Observations on Behavioral Economics and the Creation of the Consumer Financial Protection Agency

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I.

As some critics have noted,[1] the White House's proposal to establish a new Consumer Financial Protection Agency (CFPA) seems to be based – at least in part – on behavioral economics theory. Consequently, I'd like to briefly discuss my own views about that theory. I have five observations in this regard.

First, insofar as antitrust is concerned, behavioral economics is relatively new.

The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisors, Amanda Reeves and Beth Delaney, for their invaluable assistance preparing this paper. I presented Part I and Part II of these remarks at the Conference's morning and afternoon sessions, respectively.

[1] See, e.g., Richard A. Posner, "Treating Financial Consumers as Consenting Adults," THE WALL STREET JOURNAL (July 22, 2009) ("The plan of the new agency reveals the influence of 'behavioral economics,' which teaches that people, even when fully informed often screw up because of various cognitive limitations."); Simon Johnson, "The Dark Side of Behavioral Economics," The New Republic (July 29, 2009), available at http://www.tnr.com/blog/the-plank/the-dark-side-behavioral-economics.

not seriously questioned. I date the Chica

"wealth-maximizing self-interest," but which we pursue anyway. I am intrigued by the prospect of incorporating these insights into the Commission's approach to antitrust and consumer protection law.

Second, behavioral economics has been described as having more relevance on the buy side – that is to say, in analyzing consumer behavior – than on the sell side.[7] For example, George Akerlof and Robert Shiller's recent *New York Times* bestseller *Animal Sprits*,

the Supreme Court,

subsequently found that the Federal Trade Commission Act[14] was not made "'for the protection of experts, but for the public – the vast multitude which includes the ignorant, the unthinking and the credulous.'"[15] The FTC, however, rejected that standard when it issued its Deception Statement in 1983, "a consumer acting reasonably under the circumstances."[16]

As far as I am concerned, there is good reason for that change. On the one hand, as Professor Meier has observed, there are certain circumstances in which consumers are prisoners of circumstances. That may be true, for example, when consumers are asked to choose between a current product or service and an alternative product or service that may be more attractive over the long run. It may also be true when there is an asymmetry of information respecting a product or the terms of an offering as between sellers and buyers. That arguably happens most often when a product is complicated (think of personal computers) or where the terms of an offering are complex (think of financial derivatives). Or, as the Commission noted in our 1983 Deception Statement, there may be certain especially vulnerable classes of consumers who cannot help themselves.[17] Children, the elderly, and the disabled come to mind. When those circumstances exist, I think that consumers deserve protection – and indeed the protection they receive should be beefed up.

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[14] 15 U.S.C. § 41 et seq.

[15] Charles of the Ritz Distributors Corp. v. FTC, 143 F.2d 676, 679 (2d Cir. 1944), quoting Florence Mfg. Co. v. J.C. Dowd & Co., 178 F. 73, 75 (2d Cir. 1910).

[16] FTC Statement on Deception ("Deception Statement"), appended to Cliffdale Associates, Inc., 103 F.T.C. 110 (1984), available at http://www.ftc.gov/bcp/policystmt/ad-decept.htm.

[17] Id. ("When representations or sales practices are targeted to a specific audience, such as children, the elderly, or the terminally ill, the Commission determines the effect of the practice on a reasonable member of that group").

On the other hand, as Professor Meier has also observed, there may be some circumstances when consumers simply do not take the time or make the effort needed to act rationally. Think, for example, of instances in which an asymmetry of information (or understanding) between sellers and buyers exists only because consumers are slothful or are otherwise willfully "ignorant, unthinking, or credulous." In those circumstances, I am not at all sure that consumers are deserving of protection by the government (or anyone else).

Fourth, that is a good segue into whether irrationality just exists on the buy side. There are arguments why it may exist on the se

Fifth and finally, although I think there is a very good case to be made for more robust consumer protection, I worry about whether behavioral economics will leave us without an "organizing principle" or, to put it differently, a default theory. Say what you will about the Chicago School. However, it did provide those of us in public law enforcement with an excellent theoretical framework upon which we could fall back in making our decisions. I am concerned that we may be left with nothing so comforting if we simply posit that sellers or buyers act irrationally. Perhaps, though, that result can be avoided by replacing that theoretical framework with a series of practical questions that we should ask before proceeding—as, for example, whether there is informational or understanding asymmetry; whether that asymmetry is beyond the control of the individuals involved; whether there is indeed an agency problem.

I can give you two such examples of possible doctrinal modifications on the antitrust side that reflect such a framework. First, as I suggested last June at the Bates White Antitrust Conference, one way to inject more of a consideration of the parties' actions (as opposed to theoretical assumptions about their actions) is by applying a structured rule of reason analysis in Sherman Act Section 1 and 2 conduct cases. There are two essential ingredients of the analysis. The first ingredient is proof of a practice which, considered in context, is "inherently suspect" under the antitrust laws because it is likely to adversely impact consumer welfare. The second ingredient is an analysis of the efficiencies stemming from the conduct. By engaging in a fact-bound analysis of the conduct and its anticompetitive effect rather than, as the Chicago School would have it, assuming that certain conduct is inherently pro-competitive, I believe the Commission

could incorporate insights from the behavioral economics literature in a way that would still put firms on notice of the type

to do that. And it is still another thing to say that such agency should replace an existing agency like the Federal Trade Commission (FTC) which did the best with the resources it had to protect consumers from the financial crisis that we recently experienced. I have no problem with the first proposal. I have great doubts about the second. And, as I have told the relevant elected representatives on the Hill, I think the third is bad public policy.

As matters now stand, I have four fundamental concerns about the proposed legislation now pending in the Senate. First and foremost, this proposed bill (as well as the Administration's proposal and the legislation initially drafted by the House) appears to assume that, like some other agencies whose consumer protection law enforcement authority is transferred to the new agency, the FTC failed to perform adequately its consumer protection functions during the recent financial crisis. That assumption is fundamentally erroneous. You will notice that I stressed the words "some other agencies" when discussing the proposed transfer of authority (as well as personnel and resources) to the new agency. The proposal was based on political considerations, not the merits. That is apparent from the fact that no transfer of authority, personnel or functions of the Securities & Exchange Commission was proposed. If any agency was asleep at the switch before the recent financial crisis, it was the SEC.

By contrast, before the financial crisis arose in the Fall of 2007, the FTC worked vigorously to protect consumers in the financial marketplace. For example, with respect to mortgages, the FTC initiated its fight against deceptive subprime lending and servicing practices in 1998, when it filed its case alleging that Capital City Mortgage had taken advantage of African American consumers. Since then, the FTC has brought many actions focused on the mortgage lending industry, with particular attention to entities in

the subprime market, alleging that mortgage lenders and servicers engaged in unfair or deceptive acts and practices. Through these cases, the FTC has returned hundreds of millions of dollars to consumers.[18] I am not unmindful of the distinction that Eric Stein drew between *ex post* law enforcement activities and *ex ante* activity, and there is much in what he said about that distinction. But the FTC engaged in much *ex ante* as well. For example, it convened a May 2006 workshop on alternative mortgage products[19] and engaged in consumer education respecting the perils of certain kinds of mortgages.[20] The FTC also has provided advice and developed prototype mortgage disclosures for other federal regulatory agencies, including, I might add, the Federal Reserve.[21] The mortgage market is only one of the areas of the financial marketplace in which the FTC has been active. Other areas include – to the extent we have jurisdiction – debt settlement and collection; the marketing of subprime credit cards; payment systems (including remotely created checks); conducting research on, and drafting, consumer disclosures for a variety

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[18] *See generally* Hearing On Improving Consumer Protections In Subprime Lending, Before the Before the Subcommittee On Interstate Commerce, Trade, and Tourism of the Committee On Commerce, Science, and Transportation, United States Senate (Apr. 29, 2008).

[19] *See* "Protecting Consumers in the New Mortgage Marketplace," May 24, 2006, available at www.ftc.gov/bcp/workshops/mortgage/index.shtml.

[20] *See, e.g.*, "Home Equity Loans: Borrowers Beware," "High-Rate, High-Fee Loans," and "Reverse Mortgages: Get the Facts Before Cashing In On Your Home's Equity," available at www.ftc.gov/bcp/conline/edcams/credit/coninfo.htm.

[21] *See, e.g.*, Federal Trade Commission Staff Comment to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve Board System, Regarding Proposed Illustrations of Consumer Information for Subprime Mortgage Lending (Nov. 2007), (comment to the OCC; the Federal Reserve Board; the FDIC; the OTS; and the NCUA), available at www.ftc.gov/opa/2007/11/mortgage.shtm; Federal Trade Commission Comment Before the Board of Governors of the Federal Reserve System, Docket No. OP-1253: Unfair and Deceptive Practices in the Mortgage Lending Market, Alternative Mortgage Products, and Informed Consumer Choice in the Mortgage Marketplace (Sept. 2006), available at www.ftc.gov/opa/2006/09/fyi0661.shtm.

of products with financial components,[22] the protection and use of credit scores and educating consumers about their importance; and pay day loans – to name just some of the areas.

The credit for those consumer protection activities must largely be given to our staff and more specifically to Peggy Twohig, whom Eric enticed over to Treasury. But there are still a number of superstars at the FTC's Bureau of Consumer Protection, as well as the Bureau of Economics. And they are perfectly capable of conducting research, and based on the results of that research (or, insofar as their information is proprietary, based on their independent judgment), advising other agencies about consumer disclosures.

Second, the current draft of the legislation proposed by the Senate could be read to prevent the FTC from adequately enforcing even Section 5, which is its core consumer protection law enforcement statute. For example, although the Senate proposal purports to except from transfer to the new agency the FTC's enforcement authority under Section 5,[23] it also transfers to the CFPA exclusively "all consumer protection functions of the Federal Trade Commission,"[24] which are broadly defined to include all "research,

[22] The Commission has a long history of conducting empirical tests of the efficacy of disclosures in a wide variety of commercial contexts. For example, the FTC staff released a study showing that broker compensation disclosures that the Department of Housing and Urban Development had proposed confused consumers, leading many of them to choose loans that were more expensive. See Federal Trade Commission, Bureau of Economics Staff Report, The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment (February 2004). Another example is seminal empirical research conducted by FTC staff on rent-to-own transactions, including evaluating consumer disclosure requirements. See Federal Trade Commission, Bureau of Economics Staff Report, Survey of Rent-to-Own Customers (April 2000).

[23] Section 1061(b)(5)(C)(ii).

[24] Section 1061(b)(5)(A).

rulemaking, issuance of orders or guidance, supervision, examination and enforcement activities, powers and duties relating to the provision of consumer financial products or services.[25] At a minimum, the language of the proposed legislation could be read to prevent the Commission from conducting research or issuing guidance under Section 5 of the FTC Act, as well as the enumerated consumer laws and other areas where the Commission has traditionally conducted research, provided business guidance, and marshaled consumer education efforts.

Professor Barkow's wise admonition that agency "capture" should be avoided can't be used as an excuse for the proposed transfer as it relates to the FTC either. To begin with, while she is correct that agency "capture" is a substantial potential problem, my personal view is that that problem can't be solved by any agency design because no design can be expected to be perfect. The best defense against agency "capture" is an experienced professional staff dedicated to the consumer protection mission. That said, the institutional structure of the FTC is about as close to meeting the criteria that she identified for avoiding agency "capture" as any agency I've seen in Washington.

Specifically, the FTC meets each and every one of her criteria for avoiding agency "capture." Importantly, it is an independent agency: in fact, I recall several instances in the early 1970s when the FTC's Chairmen wrote letters to Cabinet members who were trying to influence the Commission's prosecutorial decisions, reminding them that the FTC was an independent agency and would make its decisions accordingly. The FTC is also a bipartisan agency – currently composed of a Democrat, two Republicans and an Independent. Professor Barkow said it took 20 months for President Clinton and

[25] Section 1061(a)(1).

broad spectrum of arguably "financial" acts practiced by individuals and firms not normally considered as financial institutions.[26]

Fourth, the proposed Senate bill could be read to hinder the role the Congress has heretofore given the FTC in vigorously challenging violations of the Equal Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Truth in Lending Act, the Home Ownership and Equity Protection Act, the Electronic Funds Transfer Act, and the Gramm-Leach-Bliley Act. To the extent the FTC retains any authority at all to enforce those statutes, it could apparently do so only after first recommending that the new agency initiate an enforcement proceeding itself, and initiating an enforcement proceeding only after the new agency does not do so within four months of receiving the recommendation. It goes without saying that with respect to cases involving fraud, where immediate action is needed to stop consumer injury and freeze assets for consumer redress, that waiting period would severely impair the FTC's effectiveness.

The final version of the consumer financial protection legislation voted out by the House late last fall tackled and addressed each of these concerns, and I will be eternally grateful to Chairman Frank for that. The markup of the Senate version of the proposed legislation is ongoing, and what will happen to it is anyone's guess, particularly now that

[26] Section 1002 (5) defines "consumer financial product or service" as "any financial product or service to be used by a consumer primarily for personal, family, or household purposes." Section 1002 (14) defines "financial product or service" as meaning "any product or service that, directly or indirectly, results from or is related to engaging in 1 or more financial activities." Section 1002 (13)(O), in turn, includes within the definition of "financial activity," "engaging in any other activity that the CFPA defines, by rule, as a financial activity . . . ."

Senator Dodd has announced he will not stand for re-election. But I am hopeful that progress can be made on that front as well to alter the proposal to best protect consumers.