BEFORE THE

BUREAU OF CONSUMER FINANCIAL PROTECTION

WASHINGTON D.C. 20552

In the Matter of Docket No. CFPB-2018-0011

Adopted Regulations and

New Rulemaking Authorities

COMMENTS OF THE COMPETITIVE ENTERPRISE INSTITUTE

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Interest of Commenters

On behalf of the Competitive Enterprise Institute (CEI), we are pleased to provide the following comments on the Bureau of Consumer Financial Protection's (Bureau or BCFP) Request for Information (RFI) regarding Adopted Regulations and New Rulemaking Authorities.

Founded in 1984, the Competitive Enterprise Institute is a non-profit research and advocacy organization that focuses on regulatory policy from a pro-market perspective. A strong focus of CEI is on removing regulatory barriers that deny access to capital and credit to businesses, consumers, and investors.

Introduction

When the Dodd-Frank Wall Street Reform and Consumer Protection Act was established in 2010, it allocated considerable power to the BCFP. Dodd-Frank transferred rulemaking authority over a vast number of statutes from other federal regulators to the Bureau, and vested it with new powers. That new rulemaking authority includes Section 1071 of Dodd-Frank, which expands the Equal Credit Opportunity Act (ECOA) to cover women- and minority-owned small business loan data, as well as creating a new "abusive" standard to accompany the prohibition of "unfair" and "deceptive" or acts or practices (UDAAP).

For reasons discussed below, both of these new authorities are ill conceived. CEI supports their repeal. However, because their implementation is required by statute, the question turns to how the Bureau can best design implementing regulations that limit the damage to both consumers and the financial services industry.

Implementing Section 1071

Section 1071 of the Dodd-Frank Act amended the Equal Credit Opportunity Act to require financial institutions to collect, report, and make public certain information concerning credit applications made by women- and minority-owned small businesses. The purpose of the amendment is twofold:

1) To "facilitate enforcement of fair lending laws;" and
2) To "enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned, minority owned, and small businesses."[1]

The ECOA was intended to ensure that all consumers have equal opportunity in credit applications.[2] However, extending the ECOA to cover small business lending is problematic, because commercial lending is a completely different animal from consumer lending.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act §1071(b), 15 U.S.C. § 1691c-2.

[2] Daniel Press, "The CFPB and the Equal Credit Opportunity Act: How Regulators Can Improve Consumer Protection and Access to Credit," *On Point* No. 244, Competitive Enterprise Institute, May 15, 2018, https://cei.org/content/cfpb-and-equal-credit-opportunity-act.

Lenders' predominant consideration in determining whether a consumer is a good credit risk is the consumers' ability and intent to pay. To make this determination, lenders typically review a consumer's credit score and conduct a debt-to-income calculation. But the process for a small business loan is completely different.

Unlike consumer credit products that typically involve a limited number of variables to be considered in the underwriting process, lending to small businesses is highly tailored and dependent on any number of relevant variables, such as local economic conditions, the competitiveness of a specific industry, assessments of the businesses profitability and longevity, and a host of other factors.[3]

Community banks, the largest suppliers of credit to small businesses,[4] commonly employ "soft information" in underwriting a loan, as many of their small business clients lack the established credit histories suitable for the kind of quantitative analysis conducted by larger banks. Community banks have a competitive advantage in personalized, relationship-based lending grounded in local knowledge. This can lead to a variety of different decisions by a loan officer, which are not so easily understood in the abstract. One responder to the Bureau's Request for Information regarding Section 1071 small businesses lending rules summarized the problems well:

> Small Business lending is a unique process between the client and the bank and does not lend itself to the homogenous pools of lending you find in consumer credit. Banks are required to manage risk and have varying levels of expertise in areas of small business lending. A loan priced properly for the risk may be acceptable for one institution and not acceptable [for] another. For example[,] a client requests funds to open their second doughnut shop in town. One bank declines the loan because they do not specialize in food service business per lending policy and the bank[']s appetite for risk. Another bank would consider the loan, however[,] after reviewing the current competition decides that the market is saturated and the loan is too risky based on the three competitors within five miles. The third bank is willing to loan the money based on the cash flow of the owner and her husband, but will not take into account the expected cash flow from the business, and will require the collateral to include the primary residence of the client. The fourth bank is an [Small Business Association] lender and proposes the client use the SBA program to mitigate the risk for the bank. The fifth bank declines the loan due to cash flows. They will not consider the revenues from the new location, because it is considered a start-up business.[5]

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[3] America Bankers Association, "Fair Lending," White Paper, April 2017, https://www.aba.com/Compliance/Documents/FairLendingWhitePaper2017Apr.pdf.

[4] Bureau of Consumer Financial Protection , Key Dimensions of the Small Business Lending Landscape, May 2017, https://www.consumerfinance.gov/data-research/research-reports/key-dimensions-small-business-lending-landscape/.

[5] Doug Mitchell, "Comment on the Consumer Financial Protection Bureau (CFPB) Notice: Requests for Information: Small Business Lending Market," CFPB-2017-0011-0256, August 21, 2017, https://www.regulations.gov/document?D=CFPB-2017-0011-0256.

Small business lending decisions are not easily placed into government-mandated boxes for purposes of identifying discrimination. Soft information allows a bank to offer more personalized services. As each small business has unique credit needs, small business lending does not require a standardized application process. Current lending practices would not conform to the data collection efforts mandated by Section 1071, let alone provide reliable information for fair lending enforcement actions. As the American Bankers Association has argued, "the great variations and unique attributes of individual small business loans will make legitimate comparisons excessively difficult, if not impossible."[6]

Creating an ECOA liability standard for commercial loans will eliminate the relationship based lending model employed by small banks, and shift toward a model where only businesses with established credit scores are considered for loans.

Another major problem is the cost of compliance. Regulators may not see a problem with adding more and more paperwork and compliance burdens on regulated firms, but for businesses, especially for regional and community banks, it is a major problem.[7]

Around 98 percent of women- and minority-owned businesses fit the Small Business Administration's revenue-based definition of "small business," under $7.5 million in average annual receipts.[8] Small businesses, as the BCFP has found, are highly dependent on reliable access to credit. For instance, there is a strong correlation between a small business' ability to access credit and its ability to hire, maintain adequate inventory, and expand.[9]

Community banks provide a significant share of the credit extended to small businesses, despite their holding a relatively small share of banking industry assets. Community banks cannot afford the compliance burden of a broadly implemented Section 1071. A 2009 Government Accountability Office analysis of the potential costs of the kind of data collection required under Section 1071 warned that the law would impose major compliance burdens.[10] For many small banks, having to implement new information systems and training and hiring new compliance staff would pose a threat to their profitability. For example, a 2013 study by the Federal Reserve Bank of Minneapolis found that around 13 percent of banks with assets less than $50 million would become unprofitable if their compliance staff increased by one person.[11] Large compliance burdens disproportionately harm small banks, the lifeblood of small business lending.

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[6] ABA, "ABA Concerned about Feasibility of Small Biz Data Collection," *ABA Banking* Journal, September 14, 2017, https://bankingjournal.aba.com/2017/09/aba-concerned-about-feasibility-of-small-biz-data-collection/.

[7] The Paperwork Reduction Act, for example, was established to mitigate the tendency of federal agencies to impose excessive paperwork burdens on citizens and businesses.

[8] BCFP, Key Dimensions of the Small Business Lending Landscape.

[9] Ibid.

[10] Government Accountability Office, "Fair Lending: Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts," GAO-09-704, July 15, 2009, https://www.gao.gov/products/GAO-09-704.

[11] Ron J. Feldman, Jason Schmidt, and Ken Heinecke, "Quantifying the Costs of Additional Regulation on Community Banks," Federal Reserve Bank of Minneapolis Economic Policy Papers, May 30, 2013, https://www.minneapolisfed.org/research/economic-policy-papers/quantifying-the-costs-of-additional-regulation-on-community-banks.

Fortunately, while the Bureau is statutorily required to promulgate a rule under Section 1071, it has broad discretion in implementation. The statute says:

> The Bureau, by rule or order, may adopt exceptions to any requirement of this section and may, conditionally or unconditionally, exempt any financial institution or class of financial institutions from the requirements of this section, as the Bureau deems necessary or appropriate to carry out the purposes of this section.

The Bureau should make careful use of this authority. As noted, an overly broad implementation of Section 1071 would be self-defeating. A law designed to protect women- and minority-owned businesses would likely serve to inadvertently discourage lending to the those businesses. Rather than a broad implementation, the Bureau can use its exemption authority to exempt any financial institution under a certain asset threshold, such as $100 billion, or whatever is deemed appropriate to avoid negatively impacting access to credit for women- and minority-owned business. The Bureau could also exempt certain types of lenders, such as alternative or non-bank lenders, which would be materially harmed by the increase compliance costs.

Further, it is crucial that the Bureau rescind guidance documents recognizing disparate impact liability under ECOA. The disparate impact standard has no basis in the statute and would be extremely damaging to lawful financial institutions that engage in small business lending. As demonstrated by the string of auto-lending enforcement actions undertaken by the Bureau, aggregating such data for fair lending enforcement creates serious problems.[12] Statistical correlations that fail to capture nuanced explanatory variables will become less reliable for small business lending than they are for proving consumer-lending discrimination, particularly if they require the use of proxy metrics. And because the loan underwriting may be more individualized and complex, the temptation for the Bureau to use statistical shortcuts to allege discrimination may increase.[13] This gives financial institutions little incentive to expand their lending portfolios. If anything, the increased burden of data collection and compliance programs, combined with the risk of potential enforcement actions, will likely drive lenders out of the business.

Strict enforcement of Section 1071, combined with disparate impact liability, would likely be the reduction in access to credit for the very groups ECOA is looking to protect.

Defining an "Abusive" Standard

One of the most controversial aspects of Title X of Dodd-Frank is the creation of a new standard in consumer protection prohibiting "abusive" conduct,[14] in addition to the well-established "unfair" and "deceptive" standards. The Federal Trade Commission established the "unfair" and "deceptive" standards over several decades. The Bureau has also provided

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[12] Press, 2018.
[13] Ibid.
[14] 12 U.S.C. § 5531(a), 2010.

guidance regarding the standards.[15] Yet, the "abusive" standard has suffered from a lack of clarity—statutory, judicial, and administrative—since its inception. To date, the Bureau has only brought two enforcement actions based solely on the abusive standard. Yet, they reveal a great deal of ambiguity in their application.[16]

The Bureau defines an abusive act or practice as anything that:

> (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;
>>
>> (B) The inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
>>
>> (C) The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.[17]

The statute raises numerous concerns that cast doubt over whether the Bureau should pursue enforcement actions or rulemakings based upon the abusive standard.

First, the abusive standard is grounded in a theory known as behavioral law and economics (BLE). As discussed in my submission to the BCFP's Request for Information regarding rulemaking processes, a number of irresolvable problems with the BLE literature make it unsuitable for the analysis of consumer credit markets.[18]

Second, it relies on broad terms such as a "lack of understanding" by consumers or the alleged exploitation of consumer biases to determine whether abusing or deceptive practices have occurred. The new concepts regarding consumer "understanding" also pose serious problems for compliance. For instance, Banks have never had to conduct customer-specific inquiries regarding a consumer's "financial literacy" or understanding, especially for simple,

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[15] Interestingly, Dodd-Frank defines "unfair" but not "deceptive" behavior. The Bureau has provided guidance on deceptive behavior, which may include conduct such as misrepresentation of loan terms. See BCFP "Unfair, Deceptive, or Abusive Acts or Practices," Consumer Laws and Regulations Manual, October 2012, https://www.cfpaguide.com/portalresource/Exam%20Manual%20v%202%20-%20UDAAP.pdf.

[16] Joshua L. Roquemore, "The CFPB's Ambiguous "Abusive" Standard," *North Carolina Banking Institute*, Vol. 22, Issue 1 (March 1, 2018), http://scholarship.law.unc.edu/cgi/viewcontent.cgi?article=1459&context=ncbi.

[17] BCFP "Unfair, Deceptive, or Abusive Acts or Practices," Consumer Laws and Regulations Manual, October 2012, pp. 9, https://www.cfpaguide.com/portalresource/Exam%20Manual%20v%202%20-%20UDAAP.pdf.

[18] Daniel Press, "Comments of the Competitive Enterprise Institute: In the Matter of Rulemaking Processes," Docket No. CFPB-2018-0009*,* Competitive Enterprise Institute, https://cei.org/sites/default/files/Rulemaking_Process_RFI_-_Competitive_Enterprise_Institute.pdf.

mass-marketed products such as checking accounts and debit cards.[19] To date, adequate disclosure was believed to have addressed that concern.

Third, the statute is so broad and vague that it is difficult to determine what conduct it actually prohibits. Even the Bureau's previous director seemed to lack a clear understanding of what abusive conduct entails. In 2012 congressional testimony, former BCFP Director Richard Cordray stated that the abusive standard "is going to have to be a fact and circumstances issue" and is "not something we are likely to be able to define in the abstract."[20] Further, Cordray asserted that good businesses ought to know what constitutes abusive behavior and avoid engaging in it, while suggesting that a practice that is perfectly fine with respect to one consumer may be abusive with respect to another.[21] Since then, the Bureau has provided no clarity as to what exactly constitutes abusive conduct, such as defining "material interference" with consumer understanding or taking "unreasonable advantage" of consumer bias.

The standard appears to be so malleable that it gives the BCFP an extraordinary amount of power. This appears to be intentional.[22] The legislative history of the abusive standard reveals that Congress intentionally created it to be "flexible," in part to avoid the kind of cost-benefit analysis required under the unfair and deceptive standards.[23] Without a consideration of costs and benefits, and without a clear definition of what entails abusive conduct, the Bureau is empowered to pursue broad rulemakings and enforcement actions.

It becomes even more confusing upon application. Most UDAAP enforcement actions have alleged two or more standards for the same act or practice, such as declaring the same action both unfair and abusive, making it difficult to clearly delineate the differences between the abusive standard and the unfair or deceptive standards. When courts have considered the issue, they have avoided addressing it. For example, in *BCFP v. CashCall*, a case involving an online lending company accused of deceptive and abusive conduct, the judge ruled that since the defendant engaged in deceptive conduct, there was no need to consider whether abusive conduct also occurred.[24] To date, there have only been two

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[19] Joshua Wright, "Dodd-Frank's Abusive Standard: A Call for Certainty," *Berkley Business Law Journal*, Vol. 8, Iss. 2, 2011.

[20] Richard Cordray, "How Will the CFPB Function Under Richard Cordray: Hearing Before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs," Before the House Committee on Oversight and Government Reform, 112th Congress, 2012, p.73, http://oversight.house.gov/wp-content/uploads/2012/06/01-24-12-Subcommittee-on-TARP-Financial-Services-and-Bailouts-of-Public-and-Private-Programs-Hearing-Transcript.pdf.

[21] Hester Peirce, "CFPB Knows Abuse When It Sees It," Mercatus Center, March 29, 2012 https://www.mercatus.org/expert_commentary/cfpb-knows-abuse-when-it-sees-it.

[22] In *BCFP v. ITT Educational Services*, the judge ruled that the abusive standard is not unconstitutional for vagueness, because legislative intent shows it to be an intentionally "flexible standard" and the statute provides "at least the minimal level of clarity" demanded by the Constitution.

[23] Unfair acts or practices are permissible if they are "outweighed by countervailing benefits to the consumer," whereas abusive acts or practices are prohibited regardless.

[24] Roquemore, "The CFPB's Ambiguous "Abusive Standard," citing *BCFP v. CashCall*, 2016.

enforcement actions alleging solely abusive conduct. Yet even in these cases, the abusive and unfairness standards seem to be interchangeable.[25]

As Joshua Wright, then the Chief Regulatory Counsel of Wells Fargo, points out in the *Berkley Business Law Journal*, the costs associated with legal uncertainty can be enormous:

> Unless the Bureau takes early steps to clarify its enforcement intentions and create regulatory safe harbors, the likely consequences of the "abusive" standard in the Act—or more precisely, banks' fears about how the standard will be enforced—could be significantly less financial product innovation, a reduction in consumer choice, and an increase in the cost of banking products to consumers. Banks may begin to limit themselves to "plain vanilla" products and services to avoid scrutiny by the Bureau and the risk that explanations of more complex products will not be adequate under the new standards of the Act.[26]

The benefit to consumers of the abusive standard is unclear at best. Given that there is no higher penalty for violating multiple UDAAP standards, it does not even serve to impose higher penalties. Meanwhile, financial institutions are mired in confusion as to whether their actions may be interpreted under a vague and broad statute that relies on inherently subjective standards, such as a consumer's "lack of understanding."

The lack of clarity surrounding the abusive standard may have unintended consequences, such as chilling financial innovation and reducing access to credit for those on the financial margins. These consequences may be hard to quantify, but they are not overstated. For example, when the Office of Thrift Supervision shut down a microcredit financial product, iAdvance, under the "unfair or deceptive" standard without providing clear guidance, other financial service providers supplying microcredit pulled their products from the market due to a lack of clarity in enforcement.[27]

An ambiguous abusive standard is not conducive to a well-functioning financial market or regulatory system. Financial institutions need clarity. They cannot wait years for court decisions to determine the extent of a given regulatory scheme. Arbitrary punishment of activities long been deemed lawful is a detriment to all participants in financial markets.

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[25] Ibid, p. 198-204.

[26] Wright. Wright further explains the costs associated with the Truth in Lending Act's (TILA) ambiguity. Passed in 1968, TILA requires that lenders disclose costs and terms of credit in a "clear and conspicuous manner." Due to legal uncertainty surrounding provisions of the legislation, there were 34 official interpretations of the regulation a week before it became effective in 1969, and 10 years later the Federal Reserve had published 1500 official interpretations and more than 13,000 TILA lawsuits have been filed in federal courts.

[27] Ibid.

Acting Bureau Director Mick Mulvaney has vowed to put an end to this kind of "regulation by enforcement."[28] To make good on that promise, the Bureau must go further than simply cease enforcement actions that are not based on violations of clear and established law.

The abusive standard—if it is to exist—must be defined via rulemaking, rather than determined through enforcement. As defined in the statute, the term is extremely broad and could theoretically encompass any number of violations. It would not take much prompting for an aggressive director to take advantage of such a far-reaching statute. If the abusive standard is not defined now, it is only a matter of time before regulation by enforcement is back again.

At a minimum, if the Bureau cannot reasonably and clearly define what constitutes an abusive action, it should define which financial industry practices are *not* abusive, thus providing safe harbor for activities that are clearly out of the bounds of the statute.

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[28] Jackie Charniga, "CFPB's regulation by enforcement halts—for now," *Automotive News*, April 25, 2018, http://www.autonews.com/article/20180425/FINANCE_AND_INSURANCE/180429869/cfpbs-regulation-by-enforcement-halts----for-now.