"ABUSIVE" ACTS AND PRACTICES: DODD-FRANK'S BEHAVIORALLY INFORMED AUTHORITY OVER CONSUMER CREDIT MARKETS AND ITS APPLICATION TO TEASER RATES

*Patrick M. Corrigan**

The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, authorizes the Consumer Financial Protection Bureau (CFPB) to prohibit abusive acts and practices that, among other things, materially interfere "with the ability of a consumer to understand a term or condition" as well as acts and practices that take "unreasonable advantage of a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service." The project of this Note is to understand Congress's grant of abuse authority to the CFPB. The thesis is that the statutory language of the abuse authority, and particularly its focus on consumer "understanding," rejects traditional neoclassical economic logic. Instead, the abuse authority directs the CFPB to regulate problems articulated by the burgeoning literature of behavioral law and economics, particularly problems of imperfect rationality. Drawing on lessons from antitrust law, this paper proposes a legal standard for operationalizing the abuse standard. Putting this standard into practice, the paper asks whether the CFPB might be justified in regulating a common pricing structure in credit card markets—credit card teaser rates—under its abuse authority.

* J.D. 2015, New York University School of Law; Harvard Kennedy School of Government, MPP 2011. For helpful comments and direction, I am grateful to Lewis Kornhauser, John Ferejohn, Ryan Bubb, Oren Bar-Gill, Jennifer Arlen, Ricky Revesz, Tricia Corrigan, Max Sarinsky, Eddie Rooker, Matt Aulds, Erik Jerrard, Steve Hsieh, Sheldon Dutes, and Luke Herrine. I am also grateful for the support provided by the Lawrence Lederman Fellowship in Law, Business, and Economics and for helpful comments from participants in the Lederman Fellowship workshop.

Introduction

In the aftermath of the recent financial crisis and recession, Congress granted the Consumer Financial Protection Bureau (CFPB) an unprecedented legal authority to protect distressed consumers. The touchstone of this new authority is the term "abusive." The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank") authorizes the CFPB to prohibit abusive acts and practices that, among other things, materially interfere "with the ability of a consumer to understand a term or condition," as well as acts and practices that take "unreasonable advantage of a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service."[2] The CFPB's abuse authority fundamentally alters the regulatory landscape in ways that are significant and that have not yet been recognized by the agency.

The project of this Note is to understand Congress's grant of authority over abusive acts and practices to the CFPB. The thesis is that the statutory language of the abuse authority rejects a traditional neoclassical economic logic. Instead, the abuse authority directs the CFPB to regulate problems articulated by the burgeoning literature of behavioral law and economics, particularly problems of imperfect rationality.

The abuse authority covers consumer financial marketplaces in which firms offer products and services to consumers with financing needs. While shopping for the best offer, consumers may misperceive the real costs and benefits of a consumer product or service because of a lack of information about the product or service or due to a misunderstanding of the information available to them. The former is said to be a problem of imperfect information, while the latter is said to be a problem of imperfect or bounded rationality.[3] Problems of imperfect information are extrinsic to the consumer, while problems of imperfect rationality are intrinsic.

While problems arising from imperfect information can often be mitigated by policing the extrinsic environment—as exemplified by the regulatory landscape prior to Dodd-Frank—problems of imperfect

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
2. 12 U.S.C. § 5531(a) (2013).
3. *See, e.g.*, Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 Stan. L. Rev. 1471, 1477 (1998) ("Bounded rationality . . . refers to the obvious fact that human cognitive abilities are not infinite.").

understanding are not so easily mitigated.[4] These problems speak to the limited cognitive abilities of the buyer or seller.[5] Imagine a consumer surprised and outraged to discover that he exceeded the limit on his credit card and received a separate over-the-limit charge for each of his five purchases that day.[6] Consider a different consumer who is frustrated to find that his loan balance has not changed despite years of making monthly payments because he did not realize that he had signed a non-amortizing-interest-only loan with the repayment period to begin after ten years. These consumers may have misunderstood the complex terms of the credit product at the time they made the borrowing decision.

If many individual consumers in a particular market misunderstand credit products in a consistent, predictable fashion, then firms will strategically design contracts to appeal to the misperceptions of buyers.[7] Widespread problems of misunderstanding in a particular market may add up to a behavioral market failure. Instead of creating the most efficient and desirable contracts, sellers in markets characterized by behavioral failures design contracts to appeal to the predictable misperceptions of buyers. Because buyers misunderstand the costs of credit, some buyers pay more for credit than the amount at which they value it.

Before Dodd-Frank, consumer protection regulation—particularly the Federal Trade Commission's (FTC's) unfairness and deception authorities—was premised on the neoclassical view of consumer lending. Essentially, the regulatory concern was policing the markets for fraud and facilitating disclosure of credit terms. The new abuse standard shifts the focus of the inquiry away from the consumer's ability to reasonably avoid the product and broadens the CFPB's authority so that the CFPB may prohibit acts and practices that have the effect

---

4. *See, e.g.*, OREN BAR-GILL, SEDUCTION BY CONTRACT 9 (2012) ("Rational-choice decision-making provides tools for effectively coping with imperfect information. These tools are not used by the imperfectly rational consumer."). Moreover, recent literature questions the ability of disclosure to solve many problems in consumer financial marketplaces. *See* sources cited *infra* note 41.

5. *See generally* Jolls et al., *supra* note 3, at 1489–1508, 1522–40 (discussing the limits of human cognitive ability and highlighting several routine cognitive errors).

6. The practice of charging multiple over-the-limit fees in a single pay cycle was banned by the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734, but the example is illustrative of a misunderstanding problem. Sumit Agarwal et al., *Regulating Consumer Financial Products: Evidence from Credit Cards* 8 (Nat'l Bureau of Econ. Research, Working Paper No. 19,484, 2013) (noting that the Credit CARD Act prohibited the practice of charging more than one over-the-limit fee during any billing cycle).

7. *See, e.g.*, BAR-GILL, *supra* note 4, at 14–15 (providing a simple mathematical model to describe the mechanics of consumer misperception of credit card contracts).

of exploiting known consumer biases and thereby harming consumers.[8] Practicing the old hallmarks of good behavior for consumer credit lenders—mandatory disclosures and transparent pricing—may solve problems of imperfect information, but I argue that the abuse standard directs the CFPB to look further to problems of imperfect understanding.

The new abuse standard might have numerous applications to a consumer credit market filled with complex contracts and opaque prices. However, even if the new abuse authority gives the CFPB the power to regulate consumer misunderstanding, careful cost-benefit analyses of individual products and services is necessary to determine if particular price or product limitations are prudent.

To begin the research agenda, the final section of this Note analyzes a pricing structure used by many issuers in credit card markets: introductory teaser rates with elevated post-introductory rates. The teaser rate allows a consumer to borrow funds on the credit card during the introductory period at a relatively low annual percentage rate (APR)—as low as zero percent. After the introductory period expires, or if the consumer violates certain conditions of the contract such as making a late payment, the consumer is charged a higher annual percentage rate. The new, higher APR applies to balances accumulated during the introductory period.[9] The pricing structure of the teaser rate is puzzling at first blush because the introductory rate is often priced below the marginal cost to the issuer of providing funds to the consumer, while the post-introductory period rate is priced above the marginal cost of providing the loan to a borrower.[10] In line with Bar-Gill and Bubb’s call to examine the possibility of regulating teaser rates,[11] this Note asks if the new abuse standard in Dodd-Frank gives the CFPB authority to limit or prohibit credit card teaser rates.

The paper does not advance a perspective on whether the CFPB *should* regulate credit card teaser rates. The main analytical question of the case study is whether the CFPB has the *authority* to regulate

8. Norman I. Silber, *Reasonable Behavior at the CFPB*, 7 Brook. J. Corp. Fin. & Com. L. 87, 104 (2012). (“[Q]uery how differently the marketplace would look if the CFPB could establish a standard that shifts attention from whether buyers could have avoided injury by behaving reasonably to whether sellers could have avoided confusing consumers by conveying information fairly.”).

9. The Credit CARD Act banned issuers from applying rate increases to outstanding balances, but exempted teaser rates from the ban. Credit CARD Act §§ 101, 171 (codified at 15 U.S.C. § 1666i (2013)).

10. *See infra* text accompanying note 145.

11. Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The CARD Act and Beyond*, 97 Cornell L. Rev. 967, 1005–11 (2012).

teaser rates. Beyond compliance costs, the danger of an overly aggressive enforcement of the abuse standard is that it will over-deter socially valuable transactions. Moreover, the CFPB faces political risks in applying its abuse authority. The empirical evidence presented and the analysis of regulatory consequences may provide some guidance to policy questions, but it does not answer the question of whether regulating teaser rates is prudent policy.

After answering the issue of whether the CFPB has the authority to regulate teaser rates, Dodd-Frank requires the CFPB to weigh the benefits and costs with respect to any rule it is considering.[12] It also requires the CFPB to consider the burden and impact of the rules on regulated entities.[13] Answering those questions would require a more comprehensive analysis than is possible in this Note.

The rest of the paper proceeds as follows: Section I advances the statutory argument that the abuse standard in Dodd-Frank requires the CFPB to address problems of misunderstanding, and contrasts the abuse authority with the previous disclosure and unfairness regimes. Section II embeds the abuse authority in an economic framework. The analysis shows that the statutory language is inconsistent with the neoclassical framework and instead instructs the CFPB to address problems identified by behavioral psychology. Section III applies the behaviorally informed abuse authority to credit card teaser rates. The analysis probes the question of whether consumers misunderstand credit card teaser rates by presenting empirical evidence at the micro and macro levels. Section IV concludes.

I.
The CFPB's New Abuse Authority and Behavioral Law and Economics

A. Statutory Text of the Abuse Standard

Dodd-Frank, passed in 2010 in the wake of a financial crisis and recession, created the CFPB as an independent government agency with the purpose of protecting consumers in consumer financial marketplaces. Dodd-Frank transferred authority over many of the consumer financial protection statutes to the CFPB.[14] Importantly, Dodd-Frank also empowered the CFPB with a new consumer protection authority: the law authorized the CFPB, as well as states' attorneys general, to take any action authorized to prevent covered persons from

12. 12 U.S.C. § 5512(b)(2)(A)(i) (2013).
13. *Id.* § 5512(b)(2)(A)(ii).
14. *See infra* note 26.

committing an "unfair, deceptive or *abusive* act or practice."[15] The FTC had policed unfair and deceptive acts for decades, but an abuse authority that applied to all consumer credit markets did not exist prior to Dodd-Frank.

What is the scope of the CFPB's authority to regulate abusive acts or practices? The term "abusive," on its own, does not provide particularly useful guidance.[16] The statute does not define an "abusive" act or practice, but Congress did provide minimum standards for the CFPB in applying the abuse standard in section 1031(d) of Dodd-Frank:

> 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; (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]

Section 1031(d) therefore gives the Bureau authority to address three broad problems in consumer financial marketplaces: (1) problems of consumer misunderstanding, (2) problems of consumer incapacity, and (3) problems of consumer dependency.

---

15. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1031(a), 124 Stat. 1376, 2005 (2010) (codified at 12 U.S.C. § 5531(a)) (emphasis added). The authority for state attorneys general to bring actions in state or federal court under the unfair, deceptive and abusive authorities is found in 12 U.S.C. § 5552 (2013).

16. Abusive acts and practices are prohibited in other statutes, notably in the Home Ownership and Equity Protection Act (HOEPA) of 1994, Pub. L. No. 103-325, §§ 151–58, 108 Stat, 2160, 2190, and the Fair Debt Collection Practices Act (FDCPA), Pub. L. No. 95-109, 91 Stat. 874 (1977). The Federal Reserve has never defined the abuse standard in HOEPA, but has said that loan flipping and equity stripping are abusive. Carey Alexander, *Abusive: Dodd-Frank Section 1031 and the Continuing Struggle to Protect Consumers*, 85 ST. JOHN'S L. REV. 1105, 1123–25 (2011). Otherwise, applications of the abuse authority under the HOEPA seem to be limited. In the FDCPA, certain abusive acts are enumerated and involve actual verbal harassment or other forms of harassment such as threats of violence or use of profane language. *See* 15 U.S.C. § 1692d (2013). The finding of abusive conduct under the FDCPA is fairly circumscribed, perhaps because it is associated with a private cause of action. *See id.* § 1692k.

17. 12 U.S.C. § 5531(d).

Congress gave the CFPB authority to address problems of consumer misunderstanding in two contexts. First, the CFPB can declare an act or practice abusive if it "materially interferes" with the ability of a consumer to understand a term or condition of a consumer financial practice or service.[18] Second, it can declare an act or practice abusive if it "takes unreasonable advantage of . . . a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service."[19] From the perspective of the CFPB, therefore, declaring that an act or practice materially interferes with a consumer's ability to understand a contract term or condition seems to present a higher burden of justification than declaring that an act or practice takes advantage of a consumer's misunderstanding. The former seems to require some affirmative action of obfuscation and therefore may overlap with the authority to police deception or fraud.[20] The latter is more likely to include an act or practice that exploits a known, passive consumer bias. I will refer to these two pieces of the CFPB's abuse authority as its "misunderstanding authority."

The second problem that section 1031(d) gives the CFPB authority to address is what I call "problems of consumer incapacity." Dodd-Frank authorizes the CFPB to address such problems by allowing it to declare acts and practices abusive if they take unreasonable advantage of the "inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service."[21] The *inability* of the consumer to protect his interests is the key problem addressed in this subsection. A consumer may be unable to protect his interests because of a weak bargaining position, because he lacks resources or understanding, or for various other reasons.[22]

The final type of problem that section 1031(d) addresses is what I will call "problems of dependency." These problems arise when a provider of a financial product or service takes unreasonable advantage of the "reasonable reliance by the consumer on a covered person to act in the interests of the consumer."[23]

18. § 5531(d)(1).
19. § 5531(d)(2)(A).
20. *See id.* § 45(n).
21. *Id.* § 5531(d)(2)(B).
22. *See infra* notes 52–58 and accompanying text (examining these factors as historical justifications for unconscionability doctrine).
23. § 5531(d)(2)(C).

B. Gaps in pre-Dodd-Frank Consumer Protection Law

Prior to Dodd-Frank, the FTC and banking regulators served as the primary regulator of consumer financial marketplaces.[24] In addition to product-specific statutes, the main consumer protection regulatory tools wielded by the FTC were the unfairness and deception authorities.[25] Dodd-Frank transferred most of these functions to the CFPB, including the authority to write rules and issue guidance with respect to unfair and deceptive acts and practices.[26]

As a matter of statutory interpretation, the abuse standard must be deemed different from the unfairness and deception standards in order to avoid surplusage.[27] Congress was not merely tweaking around the edges of consumer protection policy when it created an entirely new consumer protection standard on equal footing with the decades-old unfairness and deception authorities. Congress gave the CFPB's new authority a name—the abuse authority—and devoted an entire subsection of Dodd-Frank to providing requirements for it.[28] If the abuse standard is not something different from the unfairness and deception authorities, then Dodd-Frank's grant of authority to the CFPB to prohibit "unfair, deceptive, or abusive act[s] or practice[s]" would be redundant.[29] Richard Cordray, director of the CFPB, shared this interpretation in testimony to Congress when he said that "Congress has seemed to indicate that there is a distinction among [the unfair, deceptive and abusive] categories," even if there may be some overlap

---

24. *See generally* Dale Pollak & Bruce Teichner, Comment, *The Federal Trade Commission's Deception Enforcement Policy*, 35 DEPAUL L. REV. 125, 126 (1985) ("The Federal Trade Commission Act . . . which authorizes the Commission's existence, has gradually developed from its origins as an antimonopoly law into a full-blown consumer protection statute.").

25. *See generally* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 88–97 (2008).

26. All the consumer protection functions of the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration were transferred to the CFPB. § 5581(b)(1)–(4), (6). While the FTC retains some enforcement authority, Dodd-Frank transferred the FTC's rulemaking authority under enumerated consumer law to the CFPB, including rulemaking over unfair and deceptive acts and practices. § 5581(b)(5).

27. Courts generally construe statutes to avoid surplusage. *See, e.g.*, Almendarez-Torres v. United States, 523 U.S. 224, 231 (1998) (declining to endorse a particular interpretation of a statute because that interpretation would make certain words in the statute mere surplasage).

28. *See* § 5531(d).

29. *See* § 5531(a).

between them.[30] In order to analyze the meaning of the abuse standard, it is therefore crucial to review preexisting regulatory tools that were transferred to the CFPB in Dodd-Frank.

1. *Outline of Consumer Protection Law Prior to Dodd-Frank*

Much has been written about disclosure law and the unfairness and deception authorities,[31] so this section will not outline them in detail. Rather, this section briefly considers each of the major consumer protection regimes prior to Dodd-Frank, paying close attention to their implications for the new abuse standard.[32] Credit card teaser rates, described in the introduction, are used as an example to illustrate the limits of each consumer protection standard.

i. *The Federal Truth in Lending Act*

Disclosure in consumer financial marketplaces is largely governed by the 1968 Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.[33] The purpose of Regulation Z is to "promote the informed use of consumer credit by requiring disclosures about its terms and cost" and to give consumers certain protections, such as a right of rescission, in some contexts.[34] However, the regulation "does not generally govern charges for consumer credit."[35]

For example, Regulation Z provides specific disclosure requirements in the credit card context. Applications and solicitations for credit cards must disclose, among other information, the annual percentage rate, variable rate information, over-the-limit fees, and numer-

---

30. *The Semi-Annual Report of the Consumer Financial Protection Bureau (CFPB)*: *Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. (2012) (statement of Richard Cordray, Dir., Consumer Fin. Prot. Bureau).

31. *See, e.g.*, J. Howard Beales III, *The Federal Trade Commission's Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, 22 J. PUB. POL'Y & MKTG. 192 (2003); Jack E. Karns, *The Federal Trade Commission's Evolving Deception Policy*, 22 U. RICH. L. REV. 399 (1988); Pollak & Teichner, *supra* note 24.

32. It is worth pointing out that Congress has also passed several statutes providing consumer protection laws in particular markets that will not be discussed here, as well as protections against discrimination in lending. These statutes include the Truth in Lending Act, codified at 15 U.S.C. §§ 1601–1613 (2006), 1631–1649, 1661–1667f (2006); Fair Credit Reporting Act, codified at 15 U.S.C. §§ 1681–1681x (2006); Fair Debt Collection Practices Act, codified at 15 U.S.C. §§ 1692–1692p (2006); Equal Credit Opportunity Act, codified at 15 U.S.C. §§ 1691–1691f; and the Home Ownership and Equity Protection Act of 1994, codified at 15 U.S.C. § 1639 (2006), among others. Additionally, many states have their own consumer protection laws.

33. The Truth in Lending Act is codified at 15 U.S.C. §§ 1601–77 (2013). Regulation Z is codified at 12 C.F.R. § 226 (2014).

34. 12 C.F.R. § 226.1(b).

35. *Id.*

ous other fees, charges, and conditions.[36] Notably, for the case study below, Regulation Z requires a disclosure of any "[d]iscounted initial rate"[37]—what is commonly referred to as a "teaser rate." The application for a credit card must include the initial rate and the time period over which the initial rate persists, and it must use the word "'introductory' or 'intro' in immediate proximity to the introductory rate."[38] The application must also disclose the rate that will apply after the introductory rate no longer applies.[39]

The focus of TILA and Regulation Z is on inclusion and comprehensiveness of information available to the consumer.[40] While TILA addresses problems of imperfect information, it does not require the regulator to inquire into whether or not the consumer *understands* the information in the disclosure.[41] TILA addresses problems of imperfect information but not problems of misunderstanding.

ii. Unfairness Authority

Through Section 5 of the Fair Trade Commission Act of 1914, Congress created the FTC and empowered it to prohibit unfair acts and practices in commerce or affecting commerce. In current jurisprudence, an act or practice is unfair only if it "cause[s] substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[42] The statute permits the FTC to consider prevailing

36. *See* § 226.5a(b) (Credit and Charge Card Applications and Solicitations).

37. § 226.5a(b)(1)(ii).

38. *Id.*

39. *Id.*

40. *See, e.g.*, Rebecca Schonberg, *Introducing "Abusive": A New and Improved Standard for Consumer Protection*, 100 CAL L. REV. 1401, 1408–09 (2012).

41. Recent research casts doubts on the effectiveness of disclosure when underlying contract terms are complex. *See, e.g.*, BAR-GILL, *supra* note 4, at 98–99; Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593, 1637–44 (2014); Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 260–61 (2006); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 712 (2006).

42. 15 U.S.C. § 45(n) (2013). The statute codified a policy statement that the FTC adopted in 1980. *See* Letter from FTC Comm'rs to Wendell H. Ford & John C. Danforth, Senators (Dec. 17, 1980), [hereinafter FTC Policy Statement on Unfairness], *available at* http://www.ftc.gov/public-statements/1980/12/ftc-policy-statement-unfairness. *reprinted in* Int'l Harvester Co., 104 F.T.C. 949, 1070 –76 (1984). The FTC adopted this policy statement in reaction to popular and congressional anger at the FTC's perceived overreach in proposing to apply its unfairness standard to prohibit advertisements on all children's television programs. *See, e.g.*, J. Howard Beales, III, *Brightening the Lines: The Use of Policy Statements at the Federal Trade Commission*, 72 ANTITRUST L.J. 1057, 1064–65 (2005) ("Many of the rulemaking proposals

public policies in making unfairness determinations, but such policy considerations "may not serve as a primary basis for such determination."[43]

As a necessary condition for a finding of unfairness, the consumer must not have been able to reasonably avoid the alleged consumer harm. The reasonableness inquiry focuses on whether there were other market alternatives that consumers in fact use.[44] The reasonableness requirement eliminates the possibility that regulators might classify teaser rates as unfair acts or practices. Consumers can shop for credit cards from numerous issuers offering a menu of pricing terms. Consumers may also avoid teaser rates by using debit cards to pay for transactions and by getting a bank loan to satisfy their financing needs.

Even upon a finding that the consumer could not reasonably avoid the alleged consumer harm, a finding of unfairness requires an additional balancing test. An act or practice that harms particular consumers may not violate the unfairness standard if prohibiting the act or practice would have adverse effects on the price or market. For example, prohibiting credit card teaser rates would raise the price of borrowing for some users of credit cards. The costs to so-called "naïve" consumers would have to be weighed against the benefits of cheaper credit card prices for more sophisticated consumers. Moreover, banning teaser rates might make markets less efficient if teaser rates efficiently compensate consumers for switching costs between cards.[45]

iii. Deception Authority

Since the FTC clarified its official interpretation of the deception authority in its 1983 policy statement on deceptive acts, an act or practice is deceptive if it is likely to mislead consumers acting reasonably under the circumstances, thereby causing material harm.[46] This policy

---

were intensely controversial. . . . But the boulder that broke the camel's back was the proposal to ban all advertising on children's television. That proposal marked a turning point and provoked a tremendous political outcry."). After the rule proposal, the *Washington Post* labeled the FTC the "national nanny." Editorial, *The FTC as National Nanny*, WASH. POST, Mar. 1 1978, at A22.

43. § 45(n).

44. FTC Policy Statement on Unfairness, *supra* note 42, at 1073–74.

45. *See generally infra* notes 146–48 and accompanying text.

46. *See* Letter from James C. Miller, III to Rep. John Dingell (Oct. 14, 1983), [hereinafter FTC Deception Policy Statement], *available at* http://www.ftc.gov/bcp/policystmt/ad-decept.htm, *reprinted in* Cliffdale Assocs., Inc., 103 F.T.C. 110, 174–84; *see also* Karns, *supra* note 31, at 407; Pollak & Teichner, *supra* note 24, at 132. Some commentators argue that the FTC Deception Policy Statement was an inaccurate characterization of case law that had the effect of narrowing the FTC's deception author-

statement continues to guide enforcement actions under theories of deception. Critically, the deception standard requires an affirmative misstatement, misrepresentation, or concealment of a material term.[47]

The focus of the FTC's deception doctrine is on the integrity of information. The deception authority polices fraud but not problems of pure misunderstanding absent seller misconduct.[48] The standard asks if the interpretation by the consumer is objectively a reasonable one, taking into account any characteristics of the group at which the alleged deception is targeted.[49] Consumers acting reasonably in the circumstances are usually able to avoid specific contract terms and prices when they have many issuers, and product options like those that exist in credit card markets. Therefore, deception doctrine is unable to limit or prohibit a teaser rate pricing structure that follows all disclosure rules and that is enforced as represented to the consumer.

Of note, Dodd-Frank may have fundamentally altered deception doctrine and unfairness doctrine because the statute refused to point to unfairness and deception in previous law, choosing instead to leave the terms undefined.[50] Dodd-Frank might give the CFPB the ability to shape the unfairness and deception standards differently. However, the CFPB does not appear eager to change these standards. The CFPB's examination manual defines unfair and deceptive acts and practices in a way that is in line with the previous doctrine and consistent with the FTC policy statements.[51]

---

ity. Whereas courts had stepped in whenever the advertisement had the capacity or tendency to deceive, the FTC policy statement required the finding of an actual deception in order for an act or practice to be deceptive. *See, e.g.*, Karns, *supra* note 31 at 143 ("The Policy's requirement that an advertisement be 'likely to deceive' consumers is a blatant departure from the previously established 'tendency or capacity to deceive' standard.").

47. Pollak & Teichner, *supra* note 24, at 143; Schonberg, *supra* note 40, at 1411.

48. *See* Karns, *supra* note 31, at 411 ("The 'reasonable consumer' standard is based upon the premise that consumers generally are capable of protecting themselves from unscrupulous trade practices. The free enterprise system should therefore be permitted to determine the validity of advertising claims.").

49. FTC Deception Policy Statement, *supra* note 46, at 175.

50. Carey Alexander shows that the finalized Dodd-Frank statute included language from the White House's policy paper providing the CFPB with more leeway in using public policy as a basis for a finding of "unfairness." Alexander, *supra* note 16, at 1118; *see also* 12 U.S.C. § 5531(c)(2) (2013). Deception authority experienced a more ambiguous transformation. The final bill refused to define the term "deception," possibly giving the CFPB more leeway in defining the term away from prior jurisprudence. Alexander, *supra* note 16, at 1119.

51. *See generally* CONSUMER FIN. PROT. BUREAU, CFPB SUPERVISION AND EXAMINATION MANUAL: UDAAP 1–10 (2012), *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

iv. Unconscionability

Unconscionability doctrine provides a defense to parties being sued in court for breach of contract by allowing courts to refrain from enforcing specific terms that they find unconscionable.[52] One theory advanced to justify unconscionability doctrine is that genuine assent is undermined when one party is able to impose an unfair contract on another.[53]

However, unconscionability doctrine, narrowly applied by courts, is not a useful tool for protecting consumers on a national scale.[54] Unconscionability is limited, first, by the demanding standard that courts apply in proving unconscionability. In many jurisdictions, the plaintiff must prove both procedural and substantive unconscionability.[55] Procedural unconscionability refers to the bargaining behavior. Most courts require a finding of some sort of coercion, pressure, or significant power imbalance.[56] Substantive unconscionability refers to the terms of the contract and may be found when the contract is harsh or unduly favorable to one party.

More importantly, the "case-by-case" litigation inherent in the unconscionability remedy limits the utility of addressing harmful contract provisions in the modern economy in which form contracts are an

---

52. *See* U.C.C. § 2-302 (2012); RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

53. *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (1965) ("In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power."); *see also* Jones v. Star Credit Corp., 298 N.Y.S.2d 264, 267 (Sup. Ct. 1969).

54. *See, e.g.*, Bar-Gill & Warren, *supra* note 25, at 76 ("As currently interpreted, the unconscionability doctrine is too narrow to address many of the problems in the consumer credit market."); *cf.* RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. c (1981) ("Inadequacy of consideration does not of itself invalidate a bargain."); 8 SAMUEL WILLISTON & RICHARD LORD, A TREATISE ON THE LAW OF CONTRACTS § 18:8 (4th ed. 2010) ("The principle is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power."). Larry DiMatteo and Bruce Rich studied 187 cases in which courts considered claims of unconscionability and documented the criteria used to evaluate unconscionability in contracts and evidence required by courts to establish such a claim. Larry A. DiMatteo & Bruce Louis Rich, *A Consent Theory of Unconscionability: An Empirical Study of Law in Action*, 33 FLA. ST. U. L. REV. 1067, 1069 (2006).

55. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. c (1981). ("Theoretically it is possible for a contract to be oppressive taken as a whole, even though there is no weakness in the bargaining process and no single term which is in itself unconscionable. Ordinarily, however, an unconscionable contract involves other factors as well as overall imbalance.").

56. *See, e.g.*, *Jones*, 298 N.Y.S.2d at 266 (holding that the law normally recognizes contracts in a free enterprise system, but where there are unfair or harsh terms combined with "oppression" or "unfair surprise" in the bargaining process, the court may find a contract term unconscionable).

essential component of mass production.[57] Many consumers may abide by the unconscionable term not understanding that they have rights, or because they are deterred by litigation costs. Finally, unconscionability is limited since it does not provide damages as a remedy to consumers who have already suffered losses resulting from the unconscionable contract term.[58]

2. *Lessons for the Abuse Standard*

This brief survey of existing consumer protection regimes is meant to contextualize my later analysis of the abuse standard. Given the strong presumption against surplusage, it is reasonable to conclude that the abuse standard does not vest any authority in the CFPB that existed in these previous enforcement regimes. Therefore, Congress probably did not intend the abuse standard to address problems of imperfect information, since TILA and the deception authority police these problems.

Moreover, the inclusion of the abuse authority alongside unfairness authority suggests that Congress probably did not want to limit the abuse standard with a balancing test that weighs the harm to certain consumers against the benefits to other consumers—as provided in the unfairness inquiry. If Congress had intended such a standard, it would have expressly included it in the statute, as it did in providing the balancing test for the unfairness standard. The unfairness standard demonstrates that Congress explicitly enacts a balancing test when it intends for one to apply.

The existing legal framework provides a number of insights into what Congress intended through the abuse standard. However, a closer examination of this standard and its context in an economic framework is critical to determining precisely what the abuse standard entails. This is my task in the next section.

II.
The Abuse Standard in an Economic Framework

To understand the scope of authority given to the CFPB through the abuse standard, it is helpful to identify the problem Congress was trying to fix. A useful starting point in this inquiry is to place the abuse standard in an economic framework. The thesis of this Note is

57. Arthur Allen Leff, *Unconscionability and the Crowd—Consumers and the Common Law Tradition*, 31 U. Pitt. L. Rev. 349, 357–58 (1970) (arguing that administrative regulation is more effective at addressing mass problems in mass contracts than case-by-case litigation under unconscionability doctrine).

58. *See* Williston & Lord, *supra* note 54, § 18.17.

that the statutory language of the abuse authority rejects a traditional neoclassical economic logic. Instead, the abuse authority in Dodd-Frank directs the CFPB to regulate problems articulated by the burgeoning literature of behavioral law and economics.[59] The pre-Dodd-Frank regulatory scheme policed neoclassical market failures including fraud and imperfect information. The abuse standard adds to the consumer protection regulatory scheme the authority to address problems that originate in the consumer's imperfect rationality or willpower.

A. Neoclassical Justifications

American law and regulatory policy related to economic matters are typically rooted in neoclassical economic theory, at least for the last few decades.[60] Therefore, it is logical to begin an analysis of the abuse standard by exploring neoclassical economic interpretations of this concept.

Consumers and firms in the neoclassical model, like all economic agents, are rational utility-maximizers.[61] In the rational choice framework, demand from buyers is merely a function of benefits and prices.[62] Because buyers are rational, they accurately perceive benefits and prices when making purchasing decisions.[63] Consumer understanding and capacity are two fundamental and necessary assumptions

---

59. Two papers by Jean Braucher also link the CFPB's abuse authority in Dodd-Frank to the behavioral law and economics literature. Jean Braucher, *Form and Substance in Consumer Financial Protection*, 7 BROOK. J. CORP. FIN. & COM. L. 107 (2012) [hereinafter Braucher, *Form and Substance*]; Jean Braucher, *Scamming Considered as One of the Exact Sciences: 19th Century American Literature Foreshadows Insights of Behavioral Economics* 31–32 (University of Arizona, Legal Studies, Discussion Paper No. 13-37, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2314071 [hereinafter Braucher, *Scamming*] ("As a result of the Dodd-Frank Act, a transition is underway in consumer protection law to expand from reliance on rational choice law and economics to also explicitly include behavioral law and economics as the basis for regulation. . . . [T]he CFPB's new anti-abuse power includes a concern with behavioral market failure.").

60. *See generally* Stephen Breyer, *Typical Justifications for Regulation*, *in* A READER ON REGULATION 59, 59 (Robert Baldwin et al. eds., 1998) (arguing that the justification for regulatory intervention arises out of an alleged inability of the marketplace to deal with particular structural problems such as rational choice failures of monopoly power, rent control, externalities, imperfect information, and excessive competition).

61. GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 14 (1976) ("[A]ll human behavior can be viewed as involving participants who maximize their utility from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets.").

62. *See, e.g.*, BAR-GILL, *supra* note 4, at 8–9.

63. *See* BAR-GILL, *supra* note 4, at 8–9.

of the neoclassical framework.[64] Markets typically produce efficient outcomes absent market distortions in this framework, and therefore regulatory interventions in markets are not justified in the absence of a market failure.[65] Therefore, a crucial analytical question in determining a neoclassical explanation for the abuse authority is what market distortion the abuse authority addresses.

Problems arising from a "lack of understanding" or "an inability" to protect one's interest do not fit neatly into any of the categories of the conventional neoclassical market failures—externalities, information asymmetries, or imperfect competition. Traditional rational choice market failures do not arise from problems originating in a lack of understanding because the whole concept that consumers might misperceive the costs and benefits of economic transactions is incongruous with the rational choice assumptions that demand is a function of accurately perceived benefits and prices.[66]

The dependency authority of the abuse standard—the authority to prevent acts and practices that take unreasonable advantage of the consumer's reasonable reliance—may be explained by neoclassical economic theory. The economics behind the reliance problem resemble those involved in the classic principle-agent problem. The consumer believes that the provider of financial goods or services, such as a company that mediates debt settlements with owners of debt on behalf of borrowers, is acting in the consumer's best interests, but in reality the provider is acting in its own best interests to the detriment of the consumer.

A model example might involve a financially distressed consumer who seeks help from a debt-settlement company that represents to the consumer that it can save the consumer money by negotiating on her behalf. The consumer, feeling constrained by her financial situation and perhaps illiterate about debt settlement negotiations, relies

64. *See, e.g.*, Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1036–37 (2012) ("The neoclassical economic edifice is built upon the foundational assumption that economic agents—individuals as well as firms—are rational maximizers. Indeed, within the model of 'perfect competition,' economic agents do not make mistakes or commit errors of any kind.").

65. *See* Breyer, *supra* note 60, at 59 ("The *justification* for intervention arises out of an alleged inability of the market-place to deal with particular structural problems.").

66. Bar-Gill argues that the introduction of imperfectly rational consumers changes the analysis for determining demand in a market, such that demand becomes a function of perceived benefits and prices rather than actual benefits and prices. BAR-GILL, *supra* note 4, at 9. On the supply side, profits also become a function of perceived benefits and prices rather than actual benefits and prices. *Id.*

on the company's representation and begins paying the company fees. The company, aware that the consumer does not have enough assets to successfully complete a debt settlement cycle, collects the fees. The CFPB brought its first enforcement citing the abuse authority in a case with precisely this fact pattern.[67]

On closer examination, however, even the fact pattern of the predatory debt-settlement company provides at best a strained rational choice interpretation of the dependency component of the abuse standard. The rational debtor should understand the incentives of the debt-settlement company and the costs and benefits of its services at the time she makes a purchasing decision, and should negotiate prices in accordance with this understanding. Absent some fraud or deception by the debt-settlement company—which would already be proscribed under the CFPB's unfair and deception authorities—or some misperception of costs and benefits by the consumer, it is unclear when a consumer would ever *reasonably* rely on a debt settlement company to her detriment in a manner consistent with a violation of the abuse authority.

Unlike the dependency authority, however, the misunderstanding and incapacity components of the abuse standard do not at all correspond to a market failure in the neoclassical framework. Some commentators have suggested that unscrupulous lending creates externalities that are not addressed by current regulations, and perhaps the abuse standard addresses these spillover externalities. For example, some scholars have argued that credit card debt may create externalities because individuals close to the debtor suffer the economic, psychological, and human effects of the bankruptcy process.[68] The tight correlation between bankruptcies and levels of credit card debt appears to support this claim.[69] Because credit card companies do not internalize the costs of bankruptcy and financial distress, they will loan more credit than is socially optimal. However, externalities most

---

67. *See infra* notes 105–109 and accompanying text.

68. *See* Bar-Gill & Warren, *supra* note 25, at 59–62.

69. *See* Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy* 71 AM. BANKR. L.J. 249, 253–54 (1997). While the correlation between bankruptcies and credit card debt is robust, it is important to note that correlation does not necessarily imply causation. There may be other factors driving both changes in credit card debt and bankruptcy filing, such as the natural business cycle of the economy. Ronald Mann explores this causal connection in more detail, finding that the effect of credit card debt on bankruptcies with a one-year time lag is not significant at the five percent level, but is significant at the ten percent level. However, the data is not ideal for drawing a causal conclusion. *See* RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD 66 (2006).

likely do not explain the abuse standard, because of the statutory language in section 1031(d). If Congress had wanted the CFPB to regulate externalities in credit markets through the abuse standard, it would have used language allowing the CFPB to prohibit actions that unreasonably cause "harm to third parties" rather than referring to consumer misunderstanding and incapacity.

Another neoclassical explanation for the misunderstanding and incapacity authorities of the abuse standard might be that consumer financial marketplaces contain information asymmetries that lead to inefficient markets.[70] However, imperfect information cannot justify the abuse standard since the standard uses the words "understand" and "understanding" rather than "information."[71] Understanding speaks to the consumer's rationality and his ability to process, make sense of, and accurately assess the information provided to him or her. Similarly, the statute encompasses situations in which a consumer shows an inability to protect his or her interest, not situations in which a consumer has an inability to acquire all the necessary information. Moreover, as developed earlier, a lack of authority to regulate information was never the main problem in consumer financial marketplaces leading up to Dodd-Frank. Federal regulators possessed powerful tools for regulating information, including a whole disclosure regime under TILA and deception authority to deal with fraud.

A final market failure that might provide a neoclassical explanation for Congress giving the CFPB authority to intervene in markets through the abuse standard is imperfect competition. However, problems of imperfect competition are best addressed at the firm level, not at the level of individual consumers. Moreover, federal law primarily deals with problems of imperfect competition through antitrust law.

Perhaps the most plausible neoclassical interpretation of consumer "understanding" is that the phrase refers to those instances when it is rational for the consumer to not read a contract due to its length or when the terms are excessively technical and require a professional degree to understand. Neoclassical economics does not consider individuals to be omniscient, but rather rational agents with

70. *See, e.g.*, Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 (1981) (showing that in equilibrium a loan market may be characterized by credit rationing due to problems of imperfect information between the borrower and the lender); Lawrence M. Ausubel, Adverse Selection in the Credit Card Market 4 (June 19, 1999) (unpublished manuscript), *available at* http://www.ausubel.com/creditcard-papers/adverse.pdf (examining empirical evidence for adverse selection in credit card markets).
71. 12 U.S.C. § 5531(d)(1)–(2)(A) (2013).

limited information. In making decisions, consumers search for information and gather an optimal amount of information before making a decision. It is possible that the length and complexity of terms in a contract make it rational for a consumer to sign without reading the contract.[72] As a practical matter, this interpretation would apply the abuse standard most forcefully to long-form and boilerplate contracts. Clauses such as mandatory arbitration provisions could be embedded in such lengthy and technically sophisticated contracts that consumers could rationally decline to read. However, this interpretation would likely not allow the CFPB to regulate terms, such as certain deferred costs, that are disclosed up front in lay language and frequently read by consumers but that behavioral economists nevertheless predict are non-salient to the consumer. As discussed later, a non-salient price is a price that the consumer does not understand or does not weigh properly in making an economic decision.[73]

There are three problems with the interpretation that the abuse standard applies only in contexts in which it is rational for a consumer to not read the contract. First, there is no basis in the statute or legislative history for limiting the phrase "lack of understanding" to this narrow, technical definition, to the exclusion of other more common meanings of "lack of understanding." The standard this Note advances would capture misunderstanding due to rational avoidance of reading contracts as well as misunderstanding due to imperfect rationality. Second, this proposed alternative interpretation would seem to suggest that Congress was unsettling the common-law contract doctrine employed in many jurisdictions recognizing a duty to read contracts.[74] Courts have long eschewed getting into the technical details of offer and acceptance, since a subjective analysis of whether the consumer had actually read the contract and understood its terms is nearly im-

72. *See* Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 216 (1995) ("I will assume that the *calculating abilities* of actors are limited in ways [actors] . . . may not be aware of, but that in determining the appropriate *amount* of search and processing actors follow the model of optimal decisionmaking procedure, so that their ignorance of undiscovered alternatives is rational, although their calculations concerning the alternatives they do consider may not be.").

73. *See infra* notes 97–104 and accompanying text.

74. *See, e.g.*, Casavant v. Norwegian Cruise Line, Ltd., 829 N.E.2d 1171, 1180 (Mass. App. Ct. 2005) (finding that terms in a contract are enforceable if the buyer had a reasonable opportunity to become aware of the term); *see also* E. ALLEN FARNSWORTH, CONTRACTS § 4.26 (4th ed. 2004) ("Courts . . . have not been receptive to the argument that a party should be relieved of an agreement on the grounds [that reading the entire contract was an imposition]. A party that signs an agreement is regarded as manifesting assent to it and may not later complain about not having read or understood it, even if the agreement is on the other party's standard form.").

possible to perform accurately.[75] If Congress wanted to upset common law, it probably would have been more explicit in doing so. Finally and most significantly, the most effective solution to the problem of rational ignorance seems to be improved mandatory disclosures, not a sweeping new consumer protection authority on par with the deception and unfairness standards.

The problems of understanding and incapacity contained in the abuse standard sit uneasily in the neoclassical framework. Indeed, the neoclassical framework assumes rational consumers, and it is impossible for rational agents to misunderstand the information available to them. The use of the word "understanding" in the abuse standard appears to reject a conventional neoclassical explanation. Similarly, issues of incapacity are not typically recognized in the neoclassical framework, in which individuals are modeled as utility-maximizing rational agents.

B. Behavioral Law and Economics Justifications

While the neoclassical framework does not fit well with the abuse standard, there is a burgeoning area of economics—behavioral economics—to which the abuse standard in Dodd-Frank might point. Unlike in neoclassical economics, behavioral economics holds that consumer misunderstanding of costs and benefits is rampant.[76] On this view, individuals do not always act rationally and often follow simple decisional rules and heuristics.[77] For these reasons, behavioral economics argues that consumers are unable to protect their interests in certain contexts.[78]

Behavioral psychology has identified three main channels through which human behavior deviates from the predictions of neoclassical economics: bounded rationality, bounded willpower, and bounded self-interest.[79] Bounded rationality refers to the fact that human cognitive abilities are not infinite and, rather, display persis-

75. *See Norwegian Cruise Line*, 829 N.E.2d at 1180.

76. *See, e.g.*, BAR-GILL, *supra* note 4, at 8–9 ; Bar-Gill & Bubb, *supra* note 11, at 971 ("According to the behavioral theory, imperfectly rational consumers place excessive weight on short-term, salient prices and insufficient weight on long-term, nonsalient prices."); Bubb & Pildes, *supra* note 41, at 1641 ("Behavioral insights suggest that consumers do a poor job of optimizing borrowing decisions when faced with complex credit contracts because they do not comprehensively understand all the contractual terms they confront.").

77. *See generally* SIMPLE HEURISTICS THAT MAKE US SMART (Gerd Gigerenzer et al., eds. 1999).

78. *See generally infra* notes 97–98 and accompanying text.

79. *See* Jolls et al., *supra* note 3, at 1477–79.

tent, predictable departures from rationality.[80] Bounded willpower refers to the observation that humans take actions that they know to be in conflict with their own long-term interests.[81] Bounded self-interest refers to the fact that humans care about the well-being of others.[82]

Evidence of bounded rationality challenges the neoclassical assumption that humans are perfectly rational. Evidence of bounded willpower and bounded self-interest challenges the rational choice assumption that humans are utility-maximizing agents. Researchers have documented numerous behaviors that deviate from the actions that neoclassical theory predicts a rational consumer would make. A basic finding, by way of example, is that individuals make financial decisions on factors other than economic fundamentals. For instance, individuals make different choices depending on whether an opportunity is presented to them as a risk of losing money or as a chance to gain money.[83] The definition of "abusive" in Dodd-Frank recognizes these intrinsic cognitive limitations through its "lack of understanding" language, and also recognizes the knowledge and power imbalances between consumers and providers of financial products and services that occur in many transactions through its "incapacity" language.[84]

The interpretation advanced in this Note—that the abuse standard is behaviorally informed—is novel and controversial. For example, Douglas Ginsburg of the D.C. Circuit, among others, has criticized the behavioral economics literature as inaccurate, insufficient to justify regulatory intervention, and a threat to liberty.[85] Critics of behavioral economics will surely argue that Congress did not intend the CFPB to use behavioral economics to inform the abuse standard.

While legislative history provides little guidance,[86] the idea that the abuse standard addresses behavioral market failures related to con-

---

80. Jolls et al., *supra* note 3, at 1477.

81. Jolls et al., *supra* note 3, at 1479.

82. Jolls et al., *supra* note 3.

83. *See, e.g.*, Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 Sci. 453, 454 (1981).

84. *See* Schonberg, *supra* note 40, at 1405.

85. Wright & Ginsburg, *supra* note 64, at 1035–36.

86. Schonberg's review of the legislative history turned up only four mentions of the term "abusive," all of which were made by various witnesses testifying at hearings. None of the discussions were in-depth. *See* Schonberg, *supra* note 40, at 1420–21. Witnesses at a July 2009 Senate hearing used the term "abusive" to refer to generally harmful practices but did not provide significant details about the standard or how it would be applied. *Id.* at 1420. Travis Plunkett, the Legislative Director of the Consumer Federation of America, provided a list of practices he referred to as abusive lending practices in his testimony. These practices included penalty rates over thirty percent, increasing interest on outstanding balances, aggressive marketing of credit cards to young people, and universal default. *Id.* at 1420–21. At a House of

sumer misunderstanding and dependency is suggested not only by a plain reading of the statute, but also by the context of Dodd-Frank. The idea to create the Consumer Financial Protection Bureau gained traction through a paper co-authored by Elizabeth Warren and Oren-Bar Gill.[87] The authors argued that markets for consumer credit products were failing because of uninformed and imperfectly rational consumers.[88] The paper is replete with evidence that firms in credit card, mortgage, and other consumer financial marketplaces exploit known behavioral biases of consumers.[89]

The Obama Administration picked up the idea for a government agency dedicated to consumer protection in a Treasury Department white paper, which also introduced the idea that the Bureau should be able to regulate "abusive" acts and practices.[90] The white paper did not define the term "abusive."and provided little context at all for the term abusive besides providing one example: "[M]ortgage companies and other firms outside of the purview of bank regulation exploited that lack of clear accountability by selling mortgages and other products that were overly complicated and unsuited to borrowers' financial situation."[91] This example does not expressly reference behavioral law and economics, but the implicit assumption motivating the example is that mortgage lenders took unreasonable advantage of the consumer's inability to make the optimal choice under these circumstances. This

---

Representatives hearing, NAACP Director Hilary Shelton testified that he thought that payday loans with an APR above thirty-six percent are abusive. *Id.* at 1421. The abuse authority was also briefly alluded to testimony by another witness at the same hearing. *Id*. Schonberg found no other significant mention of the abuse authority in the official legislative history. The on-the-record discussion of the abuse standard in the legislative history is sparse, and exhibits no unifying theme besides perhaps classifying high interest rates as abusive. *See id*. at 1420–21.

87. *See* Bar-Gill & Warren, *supra* note 25, at 98. Warren initially proposed creating a financial product safety commission one year earlier in Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY J. 8 (2007).

88. *See* Bar-Gill & Warren, *supra* note 25, at 7–8.

89. *See, e.g.*, Bar-Gill & Warren, *supra* note 25, at 7 ("The freedom-of-contract principle and faith in the value of free markets are premised on a number of assumptions, specifically that the contracting parties are informed and rational. In the area of consumer credit products, not only are these assumptions untested, but in many cases both theory and evidence suggest they are unrealistic or directly contradicted by the available data. When those assumptions are not reliable, then freedom of contract shifts from a system to enhance consumer welfare, and social welfare more generally, to a tool used by more sophisticated parties to take consumers' money without giving value in return."); *see also id.* at 26–56.

90. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 67 (2009), *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

91. *Id.* at 7.

assumption is at odds with neoclassical economics but consistent with behavioral economics.

1. *The Behavioral Explanation for Regulating "a Lack of Understanding"*

The market failure that best explains the authority of a federal regulator to address problems of consumer misunderstanding is a behavioral market failure. Behavioral market failures are not recognized in neoclassical analysis but are nonetheless well established in behavioral economics due to robust empirical evidence that humans deviate from the rationality and utility-maximizing assumptions of neoclassical theory.[92]

The behavioral economics literature is largely a collection of equilibrium models that demonstrate the distortions that arise in markets when consumer misunderstanding leads to predictable departures from rationality.[93] The language referring to "a lack of understanding" in the abuse standard seems to point to this type of market failure. Indeed, this is the only economic theory that can explain or justify the recognition and regulation of situations in which consumers lack understanding, since consumer misunderstanding is incompatible with neoclassical economics.

Under neoclassical economic analysis, contracts should be enforced as expressions of the mutual intent of the parties.[94] However, the idea that imperfect rationality should set limits on enforcement of contracts is not new. Eisenberg documents how many contract law doctrines that limit full enforcement of contracts—for example, doctrines of unconscionability and lack of capacity—are best explained as addressing problems of limited cognition.[95] Similarly, the abuse standard provides a basis for limiting the terms of contracts. If particular contractual arrangements take "unreasonable advantage of a lack of understanding" or of an "inability" to protect one's interests as stipu-

92. *See supra* notes 76–83 and accompanying text.

93. *See supra* notes 76–80 and accompanying text.

94. *See, e.g.*, Restatement (Second) of Contracts § 79 (1981) ("If the requirement of consideration is met, there is no additional requirement of (a) a gain, advantage, or benefit to the promisor or a loss, disadvantage, or detriment to the promisee; or (b) equivalence in the values exchanged; or (c) 'mutuality of obligation.'"). Even form contract terms are generally enforceable. *See, e.g.*, Graham v. Scissor-Tail, Inc., 623 P.2d 165, 172 (Cal. 1981) ("[A] contract of adhesion is fully enforceable . . . unless certain other factors are present which, under established legal rules . . . operate to render it otherwise.") (citation omitted).

95. Eisenberg, *supra* note 72, at 212 ("Some of the doctrines that limit the bargain principle, however, cannot be adequately explained on the basis of unfair exploitation. Rather, these doctrines are best explained on the basis of limits of cognition.").

lated in Dodd-Frank, then the argument that contracts should be enforced because they are the expressions of the parties' intention is undermined.[96] The abuse standard moves this basis for limiting contracts from a narrowly applied contract doctrine to a formal statutory authority enforced by a regulatory agency.

It is important to distinguish between a consumer who is rationally ignorant—as in the case of the consumer who does not read a long contract because it is not rational for her to invest her time in the effort—and an imperfectly rational consumer who has a behavioral bias. For example, a rational consumer who decides not to read the fine print will assume that the fine print is pro-seller, whereas an imperfectly rational consumer might not. Importantly, it seems that the statutory language is broad enough to cover both types of misunderstanding. The abuse inquiry turns merely on whether the seller takes unreasonable advantage of a lack of understanding. The statutory language does not articulate a particular type of consumer misunderstanding and seems broad enough to encompass all types of consumer misunderstanding.

2. *The Behavioral Explanation for "An Inability to Protect" One's Interests*

The language in the abuse standard relating to an inability of the consumer to protect his or her own interest resembles language in a seminal paper in behavioral law and economics by Russell Korobkin on standard form contracts. Korobkin explains that "whenever a term in a form contract is non-salient to most purchasers, those purchasers are *incompetent to protect their interests* vis-à-vis that term."[97] Korobkin argues that sub-optimal contract terms sometimes persist in form contracts because behavioral market failures exist when certain contract terms are non-salient—i.e., not perfectly understood and weighted appropriately in decisions—to imperfectly rational consumers.[98] In those instances in which the price is non-salient, Korobkin argues, the market check on overreaching by the seller of the consumer financial product or service is not present. The behavioral market failure therefore gives the seller an opportunity to draft unfair,

96. *See generally* Bar-Gill & Warren, *supra* note 25, at 7 ("The freedom-of-contract principle and faith in the value of free markets are premised on a number of assumptions, specifically that the contracting parties are informed and rational.").

97. Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1207 (2003) (emphasis added).

98. *Id.* at 1216–44.

harsh, or oppressive contact terms.[99] Korobkin performs the salience analysis mainly in the context of form contracts, but the analysis may be generalized to all forms of non-salient product features.

The inquiry into credit card teaser rates *infra* falls more easily into the CFPB's misunderstanding authority than its incapacity authority. Therefore, a full explanation of the incapacity authority is outside the scope of this Note, and is a ripe area for future research. I will make only two comments on incapacity authority here. First, the extent to which consumer misunderstanding feeds into the inability of a consumer to protect his or her interests is unclear. Korobkin's paper, for example, links the inability of the consumer to protect his interests to the consumer's imperfect rationality and inability to understand non-salient terms. Second, several commentators have noted that the CFPB's abuse authority draws on the equitable principles of unconscionability and addresses many of the same concerns.[100] One explanation of the CFPB's incapacity authority, therefore, may be that the statute gives the CFPB the ability to interpret and apply unconscionability doctrine more broadly.[101] Indeed, the CFPB seemed to advance this interpretation in a recent complaint against ITT Educational Services alleging abusive acts and practices.[102] One proposed modification of unconscionability doctrine that the CFPB might consider would be to drop the procedural unconscionability prong of the analysis and merely ask whether the contract's resulting terms are abusive or unconscionable.[103] The CFPB, an agency with rulemaking authority, might prove better at policing unconcionability in consumer credit

99. *See id*. at 1207. Because contract haggling in a modern economy is unlikely for many products and services, Korobkin's preferred intervention involves setting mandatory contractual terms that prevent the seller from exploiting the tendency of consumers to ignore non-salient contract terms. *Id*. at 1244–45.

100. Linda Singer writes that the abuse standard borrows from the concept of unconscionability and therefore is not constrained by the cost-benefit balancing of "unfairness." 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 & Com. L. 2, 4 (2010). Specifically, the language of § 1031(d)(2)(B) seems to draw on many of the equitable principles underlying unconscionability doctrine. Alexander, *supra* note 16, at 1122. Rebecca Schonberg argues that the abuse standard seeks to address many of the same concerns as the doctrine of unconscionability. Schonberg, *supra* note 40, at 1418.

101. *See supra* notes 55–58 and accompanying text for a discussion on the limitations of unconscionability doctrine.

102. *See infra* note 121 and accompanying text.

103. *See, e.g.*, Lewis A. Kornhauser, Comment, *Unconscionability in Standard Forms*, 64 Cal L. Rev. 1151, 1152 (1976) (noting that many exchanges governed by standard form contracts exhibit oppressive terms even though they are not procedurally defective, and recommending a legislatively imposed requirement that looks to the contract's resulting terms).

markets than courts have in the past, because the CFPB can promulgate unconscionability rules and enforce compliance on its own initiatives, thereby eliminating some of the concerns about the sparse, case-by-case nature of unconscionability litigation.[104]

C. The CFPB's Confused Interpretation of Its Abuse Authority

To date, the CFPB has yet to demonstrate a coherent and consistent understanding of its own abuse authority. Indeed, the CFPB's recent actions show that it is operating in a pre-Dodd-Frank regulatory mindset even in the limited instances in which it has invoked its abuse authority. The Supervision Examination Manual's instructions for compliance contains some indication that the CFPB understands the behavioral underpinnings of the abuse standard,[105] but the enforcement actions that invoke the abuse authority apply it to neoclassical problems of imperfect information. Since, as this Note has argued, the entire idea of consumer misunderstanding is incompatible with the neoclassical framework, it is no surprise that the CFPB's treatment of the abuse authority has been sparse and incoherent. The conceptual confusion has resulted in an articulation of the abuse standard that blurs into the deception and unfairness standards. As the 2008 financial crisis recedes into the past, the CFPB may be missing an opportunity to articulate and develop the behaviorally informed abuse standard enacted by Congress.

The CFPB had only alleged an abusive act or practice in three complaints as of the end of 2013. In one enforcement action, the CFPB alleged that a payday lender collected on loans that it knew to be unenforceable under state law because the payday lenders were not licensed.[106] The CFPB alleged that this practice was abusive because it took "unreasonable advantage of . . . a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the

---

104. *See supra* note 57 and accompanying text.

105. Braucher, *Scamming*, *supra* note 59, at 32–33. In making this point, Braucher notes that the Supervision Manual directs the agency's examiners to look for evidence of consumer misunderstanding of costs including if the "profitability of a product is dependent upon penalty fees . . . , [p]ricing structure (interest rate, points, fees) and other features and terms are combined in a manner that is likely to make the total costs of the product difficult for consumers to understand," or [c]redit products are not underwritten based upon the likely ability of the consumer to make the required . . . payments over the term of the loan." *Id*. at 33 (quoting CFPB SUPERVISION AND EXAMINATION MANUAL TEMPLATE 3–4 (2012), *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf).

106. Complaint at 18, Consumer Fin. Prot. Bureau v. CashCall, Inc., No. 1:13-cv-13167 (D. Mass. Dec. 16, 2013), *available at* http://files.consumerfinance.gov/f/201312_cfpb_complaint_cashcall.pdf.

product or service."[107] However, the facts alleged in the complaint do not support a conclusion that consumers misunderstood anything when they borrowed money and made payments on the loan. Rather, consumers never had information regarding the legal enforceability of the loans. The failure to get a license may have violated state and federal consumer protection law, but the status of the lender as licensed or not does not contribute to the consumer's understanding of the terms, costs, risks, or benefits of a payday loan. At best, the facts speak more strongly to a fraud theory rather than to a theory of misunderstanding because lenders withheld important information from borrowers.[108] Improved disclosures telling consumers that they had no obligation to pay the debt would have solved the imperfect information problem.[109] Moreover, the CFPB's deception and unfairness allegations in the complaint provide more plausible legal theories for finding a violation given the facts than an abuse allegation.

In a second enforcement action, the CFPB alleged that a debt settlement company, ADSS, knew or should have known that the numerous customers it had enrolled most likely lacked the financial means to complete the debt settlement program.[110] Despite this knowledge, ADSS still collected "enrollment" fees while providing the consumers with optimistic outlooks on the probability of success.[111] The CFPB alleged that this practice took unreasonable advantage of consumers' lack of understanding of how long it would take ADSS to settle their debts.[112] It is possible that consumers consistently misunderstand the costs and benefits associated with debt settlement services for a number of behavioral reasons.[113] However, the CFPB's complaint characterized the actions as if they constituted fraud: "Instead of negotiating any debts with creditors during the first three to

---

107. *Id.* at 21.
108. *See id.* at 16.
109. It is possible that additional information would not have solved the problem and there really is some consumer misunderstanding. However, without pleading evidence that consumers misunderstood state laws rather than that they never possessed such information in the first place, the argument that consumers misunderstood the payments is puzzling.
110. Complaint at 14, Consumer Fin. Prot. Bureau v. Am. Debt Settlement Solutions, Inc., No. 9:13-cv-80548-DMM (S.D. Fla. May. 30, 2013), *available at* http://files.consumerfinance.gov/f/201305_cfpb_complaint_adss.pdf.
111. *Id.* at 6–7, 14.
112. *Id*. at 15.
113. The CFPB also alleged that ADSS's actions were "abusive" because they took advantage of the reasonable reliance of consumers on ADSS. *Id*. This is a separate basis for an abusive act or practice, in addition to the misunderstanding basis. The reliance theory is more persuasive on these facts than a misunderstanding theory in reaching the conclusion that ADSS engaged in an abusive act.

six months of a consumer's enrollment—as it represents to consumers that it will—ADSS collects its 'enrollment' fees during this period."[114] In addition to the allegations under the abuse standard, the complaint also alleged three violations of the deception standard, including alleged misrepresentations of the amount of time it takes to settle debts.[115] As in the complaint against the payday lender, here the CFPB pled no facts indicating that consumers had imperfect understanding rather than imperfect information.

In the third and final complaint in which the CFPB has alleged abusive acts or practices, the CFPB alleged that ITT Technical Schools pushed zero-interest loans, referred to as "Temporary Credit," on to students, payable at the end of nine months.[116] The CFPB alleged that these Temporary Credit loans "operated merely as an entry point to private student loans that ITT students would be pushed into in order to repay their Temporary Credit."[117] The CFPB alleged that the private loans were "high-interest, high-fee private loans payable over ten years."[118] Behavioral economic theory would posit that these easily available, no-interest loans are a typical example of non-salient product features with high back-end costs. However, the CFPB complaint made no mention of this analysis. In one count, the CFPB alleged that ITT acted abusively by taking unreasonable advantage of the reasonable reliance of consumers on ITT.[119] It based its abusive analysis on affirmative misrepresentations made by ITT regarding the extent to which it would act in the consumer's best interests and thereby inducing reasonable reliance.[120] The CFPB also alleged in a second count that ITT engaged in an abusive act by taking unreasonable advantage of consumers' inability to protect their interests.[121] Here, the CFPB's analysis stated that ITT used an unfair bargaining position to pressure and coerce students.[122] This analysis closely resembles an unconscionability analysis.

In all three complaints, the theories for alleging an abusive act or practice blur into allegations of a deceptive act or practice, with the

114. *Id*. at 14.
115. *Id.* at 10–13.
116. Complaint at 2, Consumer Fin. Prot. Bureau v. ITT Educ. Servs., Inc. No. 1:14-cv-292 (S.D. Ind. 2014) *available at* http://files.consumerfinance.gov/f/201402_cfpb_complaint_ITT.pdf.
117. *Id.*
118. *Id.*
119. *Id.* at 31.
120. *Id.* at 6–10, 31–32.
121. *Id.* at 30.
122. *Id.*

exception of the second abusive act count in the ITT case. Perhaps the allegations in these cases fit uncomfortably under the abuse standard because the CFPB is interpreting the abuse standard under the neoclassical paradigm, whereas the plain language of the statute directs the CFPB to apply the abuse standard to behavioral market failures.

More significantly, the CFPB may be missing opportunities to remove exploitation of consumer misunderstanding from consumer financial marketplaces. Consider the contracts at issue for credit cards in a recent CFPB consent order.[123] Consumers applying for a credit card to be used for health care expenses could choose from two contract designs. The first contract contained a flat APR of 14.9% with fixed monthly payments until paid in full.[124] The second contract offered no interest if the consumer paid the balance in full within a promotional period lasting as few as six months or as many as twenty-four months.[125] However, if the consumer did not pay off the entire balance by the end of the introductory period, then an APR of 26.99% applied retroactively to the balance.[126] Perhaps not surprisingly, approximately eighty-five percent of consumers chose the contract with zero upfront interest.[127] In the consent order, the CFPB found that many sales representatives were not disclosing to consumers the terms of these contracts with sufficient clarity.[128] The CFPB issued a consent order requiring the issuer to provide more disclosures and to better communicate the terms of the contract.[129]

Should the CFPB also have ordered the company to stop using this type of contract design entirely? Such authority did not exist in any regulatory agency prior to Dodd-Frank. In the consent order, the CFPB did not in fact scrutinize the substance of the contracts to determine whether the terms associated with the promotional period took advantage of a lack of understanding on the part of the consumers. Yet the opportunity for consumers to be harmed is easy to see, for if consumers using a credit card with a teaser rate systematically overestimate their ability to pay their balances due to misperception, then they may pay more in interest than they were expecting to pay at the time they chose between the two contracts. On the assumptions that the

123. GE Capital Retail Bank, Care Credit LLC, CFPB No. 2013-CFPB-0009 (Dec. 10, 2013), *available at* http://files.consumerfinance.gov/f/201312_cfpb_consent-order_0009.pdf.
124. *Id*. at 3.
125. *Id.*
126. *Id.*
127. *Id.* at 3–4.
128. *Id.* at 4–6.
129. For terms of the consent order, see *id.* at 7–22.

company is indifferent between providing the two contracts and that consumers under both contracts time their payments in a similar manner, the company must expect approximately fifty-five percent of people utilizing the second contract to not pay their full balance by the end of the introductory period.[130] The contract at issue is particularly risky since the elevated rate applies retroactively if consumers carry a balance at the end of the introductory period. Section III below analyzes the question of whether consumers misunderstand a similar pricing structure—teaser rates—in a way that is proscribed under the CFPB's abuse standard.

D. A Proposed Legal Inquiry

The abuse standard, which does not define any of its key terms, should grant the CFPB broad authority across product lines in a $3 trillion consumer credit market.[131] Based on the analysis above, the best interpretation of "misunderstanding" under this standard is that it points to inefficiencies in consumer credit markets created by imperfect rationality that are identified by behavioral economics.

A successful abuse standard should map the sophisticated insights of behavioral law and economics onto a legal standard that operationalizes the statutory text of the abuse authority while also ensuring a non-arbitrary legal inquiry. On the one hand, the standard should be robust enough to prohibit those acts and practices that behavioral economics has shown to create distortions in marketplaces that harm consumers. On the other hand, the standard should not prohibit or excessively chill the offering of welfare-enhancing consumer financial products and services.

One straightforward translation of the statute into a legal standard might define an abusive act or practice as one that both has the effect of exploiting a known consumer bias, to the consumer's detriment, and is unreasonable. This standard would capture the heart of the shift

130. Assuming the costs of providing each contract were identical, the issuer would be indifferent as between the two contract designs when the marginal revenue generated from contract one equals the marginal revenue from contract two. Under the simplifying assumptions that a consumer would accrue identical balances and maintain identical outstanding balances across time, the company would be indifferent at the end of the introductory period as to which of the two contracts consumers chose when the percentage of users who were charged the 26.99% interest rate for failing to pay their balance by the end of the promotional period equals the APR of the first contract divided by the APR of the post-introductory rate of the second contract.

131. *See Total Consumer Credit Owned and Securitized, Outstanding*, FEDERAL RESERVE BANK OF ST. LOUIS (last updated Nov. 7, 2014), http://research.stlouisfed.org/fred2/series/TOTALSL/ (illustrating that outstanding consumer credit exceeds $3 trillion).

embodied by the abuse standard, but it would be too broad. Behavioral economics has shown that consumers predictably and consistently misunderstand even the most basic aspects of financial products, such as simple APRs.[132] If the legal standard for abusive acts and practices were formulated as above, a strict interpretation would likely prohibit any type of basic consumer lending product, such as a common bank loan. The "reasonableness" element might prevent the standard credit card contract from being prohibited under the proposed standard, but then the abuse inquiry would be reduced to a vague judicial determination of the reasonableness of credit products. Such a proposed standard is not very helpful and is unlikely to produce the benefits to consumer financial marketplaces that Congress intended when it enacted Dodd-Frank.

A better standard might be developed by looking to an area of the law that has experienced similar challenges to the ones posed by the abuse standard: antitrust law. In considering whether an agreement is anticompetitive, courts have fashioned a legal standard that is sometimes referred to as a "quick look" review.[133] A multi-step inquiry that shifts burdens between parties, quick-look review is intended to help courts sort out what types of agreements are anticompetitive, and therefore inefficient, from those agreements that look similar but that may produce pro-competitive benefits. A similar standard may help the CFPB sort out those actions that exploit consumer biases, produce inefficiencies, and reduce welfare from those acts and practices in consumer financial marketplaces that are efficient and welfare-enhancing.

Under the proposed standard, the starting point of the abuse inquiry is for the CFPB to raise a presumption that the allegedly abusive act or practice in question, or its effects on consumers, cannot be explained by neoclassical economic theory. When the act or practice involves pricing, this will usually require a showing that the prices depart from efficiency-based pricing, such as risk-based pricing in the lending context.

If the CFPB succeeds in this showing, then the burden shifts to the defendant to put forward some legitimate and legally cognizable justification for the act or practice. To be deemed legitimate, the busi-

132. *See, e.g.*, Annamaria Lusardi & Peter Tufano, *Debt Literacy, Financial Experiences, and Overindebtedness* 4–8 (Nat'l Bureau of Econ. Research, Working Paper No. 14808, 2009), *available at* http://www.nber.org/papers/w14808.pdf.

133. *See, e.g.*, Polygram Holding, Inc. v. FTC, 416 F.3d 29, 35 (D.C. Cir. 2005) (noting that to understand whether or not a rule promotes competition "may not require a full-blown market analysis").

ness purpose must have some efficiency rationale or otherwise be integral to providing the good or service. To be legally cognizable, the justification must demonstrate some other valid business purpose besides merely exploiting a consumer bias, and that the practice cannot be accomplished as efficiently in another manner that does not exploit the known consumer bias. If the defendant succeeds in this showing, then the CFPB has the burden of proving either that the justification is pretextual or inadequate as a matter of theory, or—by presenting evidence—that the consumer harm outweighs any purported benefits.[134]

The opportunity for the firm to present a legitimate and legally cognizable justification is essential to satisfy the statutory command that the CFPB prevent acts and practices that take *unreasonable* advantage of a lack of understanding or incapacity.[135] An inquiry that examines the legitimate business purpose of the act or practice is the most efficient way to translate the unreasonableness requirement of the abuse standard into a legal inquiry.

The CFPB has two main methods through which it can develop its abuse doctrine: enforcement and rulemaking.[136] Enforcement ac-

---

134. This proposed standard draws on ideas taken from Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir. They recommended that regulations require consumer credit lenders to offer every customer a basic or "plain vanilla" product before trying to sell a product with additional features. However, the proposed standard here for the CFPB's abuse authority would avoid the transaction costs associated with presenting to every consumer a plain vanilla contract, while allowing the CFPB to prohibit those deviations from plain vanilla contracts that have no legitimate business purpose beyond exploiting a known consumer bias to the consumer's detriment. MICHAEL S. BARR ET AL., NEW AMERICA FOUNDATION, BEHAVIORALLY INFORMED FINANCIAL SERVICES REGULATION 8–9 (2008), *available at* http://www.newamerica.net/files/naf_behavioral_v5.pdf. Notably, Congress deliberately removed a "plain vanilla" provision from Dodd-Frank that was similar to the proposal by Barr, Mullainathan and Shafir. *See* Schonberg, *supra* note 40, at 1421–23. The provision would have empowered the CFPB to define certain straightforward products with easily identifiable risks as "standard" and to require lenders offering more complex products to offer the plain vanilla provision alongside it. *Id.* at 1421–22. However, the fact that Congress removed that particular plain vanilla provision should not be considered an indication that a similar inquiry is not useful for operationalizing the abuse standard. As mentioned above, the abuse inquiry does not create the transactional costs associated with the plain vanilla requirement as it was written, and it would not have the adverse consequences members of Congress feared, such as destroying boutique companies offering welfare-enhancing financial products.

135. *See* 12 U.S.C. § 5531(d)(2) (2013).

136. The CFPB has litigation and other enforcement authority to prevent any covered person from engaging in unfair, deceptive, and abusive acts and practices. *See* §§ 5561–67. It also has rulemaking authority to prohibit ex ante unfair, deceptive, or abusive acts. *See* § 5531(b) ("The Bureau may prescribe rules applicable to a covered person or service provider identifying as unlawful unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.").

tions provide the CFPB with more flexibility but the least amount of control over the development of the doctrine. Without writing rules, the CFPB would yield to courts the ability to substantiate undefined terms like "abusive" and "misunderstanding."[137] On the other hand, if the CFPB develops the abuse standard through its rulemaking authority, then its interpretation will likely be entitled to *Chevron* deference.[138] Considering recent precedent from the D.C. Circuit, it is important that the CFPB carefully complete the cost-benefit analysis for any proposed rules, particularly considering whether other regulatory regimes, such as the unfairness and abuse authorities, reduce the need for the rule about the abusive act or practice in question.[139]

---

137. The enforcement approach might also yield to courts important decisions about the scope of application of the abuse standard. For example, it is not immediately clear from the statutory language whether proof of an abusive act or practice requires proof that each particular consumer the CFPB alleges suffered harm misunderstood some cost or benefit, or whether it is sufficient to show that, across the population, a substantial number of individuals misunderstand a particular product or service. In many contexts, courts do not allow statistical data to prove wrongdoing in particular cases. However, statistical data is considered a sufficient basis for finding violations in other areas of consumer financial protection law, such as Fair Lending violations of redlining and product discrimination. *See, e.g.*, Paul S. Calem & Stanley D. Longhofer, *Anatomy of a Fair Lending Exam: The Uses and Limitations of Statistics*, 24 J. REAL EST. FIN. & ECON. 207, 207 (2002) (noting that statistical analysis has played an important role in the enforcement of fair lending laws, both in compliance examinations by bank regulators and in enforcement actions pursued by the Justice Department). Since market equilibriums form based on the aggregate behavior of consumers, the statistical standard is more likely appropriate in this case.

138. *See* U.S. v. Mead Corp., 533 U.S. 218, 227 (2001) ("When Congress has explicitly left a gap for an agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation, and any ensuing regulation is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute." (internal quotations omitted)). *Chevron* deference implies that a court will only strike down the rule if it unambiguously violates the statute or if the rule otherwise has no reasonable basis. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842–43 (1984).

139. A recent D.C. Circuit decision to strike down an SEC rule requiring public companies to furnish shareholders with information about shareholder-nominated candidates for the board of directors (as well about shareholders' right to cast votes in board elections) may establish a tougher standard of arbitrary and capricious review for agencies whose statutes require cost-benefit analysis. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (holding SEC proxy rule arbitrary and capricious for not conducting sufficient cost-benefit analysis). Later cases, however, show that the D.C. Circuit was likely not applying a new standard, but rather engaging in a rigorous evaluation of the facts. *See, e.g.*, Inv. Co. Inst. v. CFTC, 720 F.3d 370, 377–78 (D.C. Cir. 2013) (distinguishing the CFTC rule in question from the SEC rule in *Business Roundtable* by noting that the latter rule, unlike the former rule, failed to adequately address whether regulatory requirements under different statutes reduced the need for, and benefit to be had from, the rule under consideration).

The case study about teaser rates discussed in Section III assumes that the CFPB is considering writing a rule declaring teaser rates as abusive.[140] Therefore, the analysis will speak to the record the CFPB needs to compile to support the rule, assuming that the agency is entitled *Chevron* deference. To justify a rule stating that teaser rates are abusive, in line with the CFPB's misunderstanding authority under 12 U.S.C. § 5531(d)(2)(A), the CFPB will have to provide a reasonable basis for finding that teaser rates take advantage of a lack of understanding of a material risk or cost in a way that is unreasonable.

III.
The Abuse Standard Applied to Teaser Rates

This Note has developed a behaviorally informed interpretation of the CFPB's abuse authority that provides clear guidance to the CFPB and states' attorneys general for policing abusive acts and practices in consumer financial marketplaces. In this Section, I analyze the application of the abuse authority developed in this Note to credit card teaser rates—a complex feature of many credit card contracts that is frequently misperceived, to the detriment of consumers.

A. The Demonstration that Credit Card Teaser Rates Cannot Be Explained by Neoclassical Economics

This Section applies the first step of the legal analysis developed in the previous Section by demonstrating that credit card teaser rates cannot be explained by neoclassical economics. In traditional neoclassical economic analysis, sellers of goods and services price their prod-

140. The rulemaking route, notably, carries political risk for the CFPB. Political opponents are sure to challenge the CFPB's authority to make behaviorally informed regulations on the basis that they are paternalistic. Consider, for example, the political turmoil caused in New York City when the city government proclaimed a ban on certain sizes of soft drinks in certain retail establishments. *See, e.g.*, Michael N. Grynbaum & Marjorie Connelly, *sixty percent in City Oppose Bloomberg's Soda Ban, Poll Finds*, N.Y. Times, Aug. 22, 2012, http://www.nytimes.com/2012/08/23/nyregion/most-new-yorkers-oppose-bloombergs-soda-ban.html. However, the political problem has both an economic and an ideological basis. Warren and Wood show that in equilibrium, voters are unlikely to demand regulations that reduce inefficiencies associated with consumer bias. Patrick L. Warren & Daniel H. Wood, Will Governments Fix What Markets Cannot? The Positive Political Economy of Regulation in Markets with Overconfident Consumers 2 (unpublished manuscript), *available at* http://poole.ncsu.edu/documents/IOworkshop—Wood—overconfidentconsumers102010.pdf. Most consumers are either unaware of their own biases and associated inefficiencies, or benefit from the cross-subsidy provided for the particular product feature toward which other consumers exhibit a bias. *See id.* at 1. Consequently, no constituency exists that cares to remove the inefficiencies from the market.

ucts equal to the marginal cost of producing them in a competitive equilibrium.[141] When a firm prices below marginal cost, not only is it incurring private losses, but it is also wasting social resources, because marginal costs exceed the benefits of the good produced or the service offered.[142] The easiest way for the CFPB to raise a presumption that teaser rates are not explained by neoclassical economics is to demonstrate that teaser rates are priced below marginal cost. This is the same proof that is necessary to prove most predatory pricing violations in antitrust law.[143]

In many situations, it will be very difficult for the CFPB to demonstrate that issuers are pricing below their risk-adjusted cost of funds.[144] However, the demonstration is not difficult in the case of teaser rates. Issuers' cost of funds has the structure of an interest rate. Issuers also face a cost from the risk of default, fixed costs associated with maintaining accounts, and variable costs associated with processing transactions. According to neoclassical analysis, issuers have a legitimate business purpose of charging borrowers an interest rate to recoup the costs of funds and administrative costs, as well as to compensate itself for the risk of default.

Many teaser rates for credit cards provide zero percent introductory interest rates for as long as eighteen months. Except perhaps in rare instances, the cost of funds is always above zero percent for issuers.[145] Even if the cost of funds is close to zero percent, there is a significant opportunity cost of capital associated with credit card lending. It is clear that teaser rates are incoherent under neoclassical eco-

---

141. Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 702 (1975) ("Under conditions of perfect competition, a firm always maximizes profits (or minimizes losses) by producing that output at which its marginal cost equals the market price."); *see also* BAR-GILL, *supra* note 4, at 49 (noting that marginal pricing is generally efficient in competitive markets).

142. Areeda & Turner, *supra* note 141, at 712.

143. One of the only viable theories in antitrust law in a predatory pricing case is when the firm charges prices that are below its marginal cost. The pricing scheme may indicate that the firm intends to drive its competitors out of the market and recoup its losses by later setting monopoly prices. *See* Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222–23 (1993) (holding that a predatory pricing theory under section two of the Sherman Act or section two of the Clayton Act must prove that the defendant's prices were set below an appropriate measure of costs and that the competitor had reasonable prospect of recouping its investment).

144. *See, e.g.*, Areeda & Turner, *supra* note 141, at 716 ("The primary administrative impediment to enforcing that prohibition [against pricing below marginal cost] is the difficulty of ascertaining a firm's marginal cost. The incremental cost of making and selling the last unit cannot readily be inferred from conventional business accounts, which typically go no further than showing observed average variable cost.").

145. BAR-GILL, *supra* note 4, at 70.

nomic analysis, for why would a profit-maximizing issuer offer free money to consumers for periods extending longer than a year? Behavioral economics provides an answer: the issuer can recoup losses incurred during the introductory period and more by exploiting consumer biases with high fees and interest rate charges after the expiration of the introductory period.

B. The Attempt to Show a Legitimate Business Justification

Under the proposed legal standard developed above, a demonstration that credit card teaser rates are priced below marginal cost should be sufficient to raise a presumption that teaser rates are not explained by neoclassical economics, shifting the burden to issuers using teaser rates to provide a legitimate and legally cognizable business justification. To be legitimate, the business purpose must have some efficiency rationale or otherwise be integral to providing the good or service. To be legally cognizable, the business justification cannot be accomplished as efficiently in an alternative way that does not exploit behavioral biases.

The principal neoclassical explanation for teaser rates is that they serve as a mechanism for compensating consumers who face switching costs.[146] There is evidence suggesting that consumers face switching costs in the credit card market.[147] However, the CFPB can rebut this justification as not legally cognizable by showing that issuers can and in fact do compensate consumers for switching costs in other ways. Cash payments are much more effective at compensating consumers for switching costs. Indeed, many credit card issuers regularly offer cash bonuses, typically between $100 and $200, for signing up with their cards and meeting certain minimal purchasing requirements.[148]

A second potential neoclassical explanation is that teaser rates bridge information gaps about product quality because they allow con-

---

146. Bar-Gill & Bubb, *supra* note 11, at 1008–09; *see also* Victor Stango, *Pricing with Consumer Switching Costs: Evidence from the Credit Card Market*, 50 J. INDUS. ECON. 475, 475 (2002) ("[The] literature shows that under a variety of conditions, switching costs lead firms to set prices that differ from marginal cost.").

147. *See, e.g.*, Haiyan Shui & Lawrence M. Ausubel, Time Inconsistency in the Credit Card Market 26 (Jan. 30, 2005) (unpublished manuscript), *available at* http://www.ausubel.com/creditcard-papers/time-inconsistency-credit-card-market.pdf (estimating average switching costs of $150).

148. *See, e.g.*, *BankAmericard Cash Rewards Visa Signature Card*, BANK OF AMERICA (last visited Nov. 15, 2014), https://consumer.bankofamerica.com/USCCapp/Ctl/entry?cid=2103541#b; *Chase Freedom Card*, CHASE (last visited Nov. 15, 2014), https://creditcards.chase.com/credit-cards/chase-freedom.aspx?iCELL=63KC&inkcashsplit=1&sapphireprefsplit=1.

sumers to test out different credit cards during introductory periods. As Bar-Gill and Bubb point out, however, credit cards are not the type of product that exhibit wide variations in quality.[149] All credit cards deliver the same service—access to money. This service is not different from one issuer to another. In their analysis of teaser rates, Bar-Gill and Bubb are able to find "no plausible efficiency rationale for teaser rates."[150]

It is possible that a credit card issuer might put forth new information during litigation or the notice-and-comment phase of rulemaking to provide a legitimate and legally cognizable business justification for teaser rates. However, according to information currently available in the public sphere, no business justification rooted in efficiency appears to exist for pricing credit cards with teaser rates.

C. Providing an Alternative Explanation for Teaser Rates as the Basis for a Rule Prohibiting Teaser Rates as Abusive Acts and Practice

Teaser rates present an optimal opportunity for the CFPB to begin defining the contours of the abuse authority through official rulemaking. The CFPB should lay out the behavioral explanations for why issuers use teaser rate pricing, and provide theoretical and empirical evidence in support of that interpretation as the basis for its rulemaking. This section argues that teaser rates are best explained as a pricing structure that takes advantage of a behavioral market failure to exploit known consumer biases to the detriment of consumers, thereby creating distortions in credit card markets.

The behavioral theory posits that teaser rates exploit consumer bias through some combination of the consumer's underestimation of his long-term borrowing and miscalculation of long-term prices.[151] The source of consumer bias in this context is time-inconsistent preferences. Consumers may have a conflict between preferences they presently hold (at the time that they choose the credit card with the teaser rate structure) and the preferences they will hold in the future (at the time they make individual borrowing and purchasing decisions). For example, suppose that an individual prefers in the present

149. Bar-Gill & Bubb, *supra* note 11, at 1010.

150. Bar-Gill & Bubb, *supra* note 11, at 1008.

151. *See, e.g.*, Bar-Gill & Bubb, *supra* note 11, at 1006 (noting that according to the behavioral theory, issuers offer teaser rates to lower the perceived price of a given contract); Bar-Gill & Warren, *supra* note 25, at 10 (noting that "creditors often design dangerous contracts as a strategic response to consumers' underestimation of the risks" of consumer credit contracts); *see also supra* Part II.B.

moment to begin an aggressive savings effort exactly six months in the future. After six months have passed, the consumer may instead decide that he wants to push the savings effort off another six months. His preferences in the earlier time period do not bind his preferences six months later. Similarly, an individual who is eating chocolate cake may genuinely prefer in that moment to begin exercising and dieting once the following week begins. When the following week rolls around, the consumer finds that his preference in the present moment is to eat chocolate cake, not to diet and exercise.

This is due in large part to an effect known as hyperbolic discounting, in which individuals discount events in the distant future at different rates than events in the short-term future.[152] Consumers who apply hyperbolic discounting may severely undervalue long-term costs. A hyperbolic discounter heavily discounts costs and benefits that she will incur in the near future, but only applies a small incremental discount for costs and benefits she will incur at a time in the more distant future.[153] Importantly, steep discounting relative to other time periods only occurs in the move from current consumption to future consumption.[154] When making the decision to consume as between two points in the future, the consumer applies a constant discount rate.[155]

Empirical evidence indicates that present-biased hyperbolic discounting is a robust phenomenon in both the laboratory and the real world.[156] The behavioral interpretation hypothesizes that teaser rates are the contractual mechanism strategically designed by issuers to exploit this consumer bias. The effect of the teaser rate contract design is to exploit the misunderstanding created by hyperbolic discounting and may constitute an abusive practice.

152. For an extended discussion of the role of hyperbolic discounting in the credit card context, see BAR-GILL, *supra* note 4, at 83–87.

153. Bar-Gill, *supra* note 4, at 83.

154. *See* Bar-Gill, *supra* note 4, at 84–85.

155. *Id*.

156. *See, e.g.*, George Ainslie, *Derivation of "Rational" Economic Behavior from Hyperbolic Discount Curves*, 81 AMER. ECON. REV. 334, 334 (1991); Stefano DellaVigna & Ulrike Malmendier, *Paying Not to Go to the Gym*, 96 AM. ECON. REV. 694, 711–14 (2006); Shane Frederick et al., *Time Discounting and Time Preference: A Critical Review*, 40 J. ECON. LITERATURE 351, 360 (2002); Jonathan Gruber & Botond Koszegi, *Is Addiction "Rational"? Theory and Evidence*, 116 Q.J. ECON. 1261, 1294 (2001); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443, 444 (1997); Brigitte C. Madrian & Dennis Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. ECON. 1149, 1179 (2001); Richard H. Thaler, *Some Empirical Evidence on Dynamic Inconsistency*, 8 ECON. LETTERS 201, 204 (1981).

Consider the effect of teaser rates on time-inconsistent preferences in the credit card market. Rational consumers will estimate their consumption decisions over time in an unbiased manner and accurately price the jump in APR. Rational consumers therefore will accurately perceive the cost of the credit card.

Consumers who employ hyperbolic discounting misunderstand the total future costs associated with the teaser rate pricing structure. Specifically, they undervalue long-term costs due to their inability to place the appropriate weight on the cost of events in the distant future. Of course, consumers can always make erroneous predictions about the costs or benefits of a product, but the complexity that is designed into credit card contracts, combined with high interest rates and the number of unpredictable external economic factors such as job losses and health issues, make teaser rates particularly susceptible to misperception.[157]

Consumers may be hyperbolic discounters through numerous channels. One such channel is optimism bias, which refers to the tendency to underestimate the probability that negative events will happen to oneself as opposed to others.[158] Optimism bias may lead consumers to underestimate total costs during the credit card selection decision if consumers systematically underestimate the probability of financially distressful events (such as unemployment or health emergencies) that would require consumers to borrow more than they originally anticipated. Relatedly, consumers may also systematically overestimate their competence, abilities, and prospects for earning more income, distorting their expectation regarding their future financial situation.[159]

Imperfect self-control is another channel through which consumers manifest time-inconsistent preferences and therefore may underestimate their credit card balances. Imperfect self-control describes the tendency of consumers to overestimate their ability to resist certain temptations despite knowing that resisting is in their best interests.[160]

---

157. *See generally* Bar-Gill & Warren, *supra* note 25, at 23.

158. *See* Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 818 (1980) (presenting evidence that a sample of college students reported above-average estimations of their own chances of experiencing positive events and below-average estimations of their own chances of experiencing negative events).

159. *See, e.g.*, Ola Svenson, *Are We All Less Risky and More Skillful than Our Fellow Drivers?*, 47 ACTA PSYCHOLOGICA 143, 146 (1981) (reporting that most people believe that they are better-than-average drivers).

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

Self-control is an important factor in consumer comprehension of the costs associated with credit cards, because credit cards separate the decision to obtain a line of credit from decisions to actually borrow money for purchases.[161] This becomes clear when the alternative to a credit card is considered—a traditional bank loan. All decisions about the amount of a bank loan are made up front at the time the loan is made. The consumer cannot borrow more at a later time when she might succumb to self-control problems. In this way, the closed-end loan serves as a commitment device.[162] In contrast, the open-ended line of credit granted to consumers through credit cards facilitates "a-little-at-a-time borrowing."[163] When a consumer with a credit card is faced in the future with a purchasing decision that she never expected to make at the time she decided to get the credit card, her earlier preferences cannot prevent her from swiping the card to make the unanticipated purchase.

Outside of the credit card context, a study by Read and van Leeuwen illustrates one example of self-control problems.[164] One experimental group was asked, deciding on that day, if they preferred to eat fruit or chocolate one week from that moment; seventy-four percent chose fruit.[165] The same group was asked a week later if they preferred to have fruit or chocolate immediately, and seventy percent chose chocolate.[166] These results departed from the predictions of rational choice theory in which individual preferences should not show significant discrepancies because preferences in the present moment

---

161. *See, e.g.*, *id.* at 1395–96 (noting that consumers may set borrowing limits at the time they obtain a credit card, but because of imperfect self-control, the future self may exceed the intended limit).

162. *See id*. The logic of the commitment function of closed-end credit may be extended to the savings context. Liquid assets, such as a checking account, pose problems of self-control because the consumer can spend the money at any time. Illiquid assets, such as real estate, remove self-control problems by preventing the owner from spending on those assets. Illiquid assets are what David Laibson calls "golden eggs." They promise to generate substantial benefits in the future, but the benefits are impossible to realize in the short term. *See* Laibson, *supra* note 156, at 445.

163. TERESA A. SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 130 (2000) ("[C]redit cards make it far easier to incur consumer debt by encouraging a little-at-a-time borrowing and too-little-at-a-time repayment."); *see also* BAR-GILL, *supra* note 4, at 87 ("This piecemeal borrowing phenomenon, or 'a-little-at-a-time borrowing,' exacerbates the self-control problem.").

164. Daniel Read & Barbara van Leeuwen, *Predicting Hunger: The Effects of Appetite and Delay on Choice*, 76 ORG. BEHAVIOR & HUMAN DECISION PROCESSES 189, 189 (1998).

165. *Id.* at 196–98.

166. *Id.*

should be stable across one week of time when no new information about the choice between chocolate or fruit is added. Self-control problems are consistent with the time-inconsistent preferences shown by the individuals in the experiment.

The exploitation of the consumer's ability to judge the amount of money she will borrow by teaser rates is compounded by the problems consumers exhibit in understanding interest rates. For example, Lusardi and Tufano report evidence from a survey asking respondents to determine the approximate length of time it would take a $1000 balance to double with a twenty percent compound APR.[167] Less than thirty-six percent of respondents answered the question correctly.[168] Nearly as many, thirty-two percent, chose a longer doubling period than is correct, a mistake that could lead to excessive borrowing.[169]

Consumers do not just struggle with compound interest calculations; they also systematically underestimate the APR associated with a loan principal and a stream of repayments. Stango and Zinman call this observation "payment/interest bias."[170] Stango and Zinman analyzed data from the 1983 Survey of Consumer Finances and report that nearly all households err on the low side when asked to infer an APR from monthly payments.[171] The median bias is approximately negative twenty-five percentage points (2500 basis points) and the mean bias is negative thirty-eight percentage points (3800 basis points).[172] Stango and Zinman hypothesize that the source of payment bias is likely related to difficulty understanding exponential growth.[173] When consumers do not understand the connection between interest rates and actual payments, it may be difficult for them to judge the true cost of the credit card.

Finally, consumer misunderstanding of total costs of a credit card may result from misperception of the total amount of time that the

---

167. Lusardi & Tufano, *supra* note 132, at 5. The survey question asked the following: "Suppose you owe $1,000 on your credit card and the interest rate you are charged is 20 percent per year compounded annually. If you didn't pay anything off, at this interest rate, how many years would it take for the amount you owe to double? (i) 2 years; (ii) Less than 5 years; (iii) 5 to 10 years; (iv) More than 10 years; (v) Do not know; (vi) Prefer not to answer." The correct answer is (ii) since the amount would double in three years and 10 months.

168. Lusardi & Tofano, *supra* note 132, at 5.

169. *See* Lusardi & Tofano, *supra* note 132, at 30.

170. Victor Stango & Jonathan Zinman, *Fuzzy Math, Disclosure Regulation, and Market Outcomes: Evidence from Truth-in-Lending Reform*, 24 REV. FIN. STUD. 506, 507 (2011).

171. *Id.* at 510, 514.

172. *Id.* at 514.

173. Victor Stango & Jonathan Zinman, *Exponential Growth Bias and Household Finance*, 64 J. FIN. 2807, 2808 (2009).

consumer will carry the balance of the credit card debt. In general, consumers carrying a revolving balance face a tradeoff between minimizing total interest payments and minimizing monthly payments. Consumers may underestimate the length of time over which they will actually pay back their debt.[174] Indeed, the Credit CARD Act required more proscribed disclosures related to the repayment period and the consequences of making only the minimum payment,[175] possibly on the theory that credit card companies were using a strategic bill design to maximize the amount of total interest consumers paid over the course of repayment. Underestimation of the length of the repayment term would lead to more payments at the post-introductory interest rate than consumers expected when they chose the card, and therefore a higher total cost associated with the credit card than consumers understood when they selected it.

It is difficult to disentangle the magnitude of these individual biases on credit card borrowers in empirical data from credit card consumers. However, it is significant that all the biases point to consumer error in the same direction—the biases create a tendency for consumers to underestimate the amount of money they will pay in interest at the post-introductory rate. The combined effect of the individual biases in the credit card context is to make the costs associated with the high post-introductory interest rate less salient than costs associated with the low introductory rate.

The result is that the imperfectly rational consumer does not view the same interest payment function as the perfectly rational consumer. The imperfectly rational consumer discounts each price term according to the salience he places on it and thereby misperceives total cost. If the CFPB finds that this lack of understanding exists and the issuer is taking unreasonable advantage of it, the CFPB might regulate teaser rates as an abusive practice.

The economic logic of non-salient price terms in credit card pricing provides interesting insights.[176] If either price term is not perfectly

---

174. BAR-GILL, *supra* note 4, at 89. Bar-Gill says that hyperbolic discounting accounts for borrowers underestimating the future repayment period.

175. Agarwal et al., *supra* note 6, at 19 (noting that the CARD Act introduced regulation specifying disclosures required in monthly credit card statements related to repayment amounts and durations).

176. *See generally* BAR-GILL, *supra* note 4 (explaining how consumers are seduced by contracts that increase perceived benefits without actually providing more benefits, and decrease perceived costs without actually reducing the costs that consumers ultimately bear); Bar-Gill, *supra* note 160 (highlighting the asymmetry between consumers and sophisticated providers through a case study on the credit card contract); *see also* Paul Heidhues & Botond Köszegi, *Exploiting Naivete About Self-Control in the Credit Market*, 100 AM. ECON. REV. 2279 (2010) (explaining that unsophisticated

salient to consumers, then issuers have an incentive to manipulate that price term.[177] The intuition is that consumers will not respond as sensitively to increases in the relatively less salient price term, so the issuer may shift revenue from the salient pricing term to the non-salient pricing term without reducing demand. In effect, the issuer can decrease the perceived cost of the credit card to the consumer without discounting the actual cost. When competing for certain types of consumers,[178] issuers have to exploit consumer misperceptions, or else they will not survive in the market.[179] A consumer who systematically underestimates long-term borrowing relative to short-term borrowing will likely choose a credit card with a teaser rate over one without because he perceives the former to be cheaper than the latter.[180] In a market dominated by a single monopolist, the monopolist issuer would not be compelled by competition to increase non-salient price terms, but doing so would increase profits from those customers who do not accurately perceive the costs of that price term.[181]

Drawing upon the concepts developed above, a simplified arithmetic example following Bar-Gill should make clear the potential that teaser rates pose for harming consumers.[182] Consider a consumer who plans to and does in fact borrow $1000 in the first year. The consumer's preference and intention are to borrow no money after the

---

credit card consumers overborrow and arguing that the prohibition of large penalties for deferring small amounts of repayment can raise welfare); Agarwal et al., *supra* note 6 (detailing the effects of the CARD Act of 2009).

177. For a formal proof of this concept, see Agarwal et al., *supra* note 6, at 22–25.

178. Specifically, naïve hyperbolic-discounting consumers.

179. Bar-Gill, *supra* note 160, at 1376–77 (2003) ("The underestimation bias does not eliminate the competition in the credit card market; it diverts competition from the interest rate to other, short-term components of the credit card contract."). Notably, Bubb and Kaufman show that abstaining from exploiting behavioral biases may give issuers a comparative advantage with sophisticated consumers who are aware of their biases and therefore seek some form of commitment device to prevent the exploitation of their bias. Bubb and Kaufman show that mutually owned firms such as credit unions, whose incentives to exploit consumer misunderstanding are less than those of investor-owned firms, perform a commitment function for sophisticated consumers by offering credit products that exploit consumer misunderstanding are less than the counterpart contracts at investor-owned firms. *See* Ryan Bubb & Alex Kaufman, *Consumer Biases and Firm Ownership,* 105 J. PUB. ECON. 39, 40 (2013).

180. *See* BAR-GILL, *supra* note 4, at 80 ("[I]f the [fees] are not salient to card-holders, issuers will raise the magnitude of these price dimensions. Increasing these prices will not hurt demand.").

181. *See* Agarwal et al., *supra* note 6, at 23 (noting that in their model of a credit card product with a salient price and a non-salient price, it is optimal for firms to set the potentially non-salient prices to the maximum allowable amount because the price increase raises profits but has no effect on demand); *see also* BAR-GILL, *supra* note 4, at 8.

182. BAR-GILL, *supra* note 4, at 14–16.

first year, and she expects to pay off the entire balance before the end of the introductory period. In actuality, her preferences change during the first year for whatever reason (she has a medical emergency, she needs to buy a new furnace, she decides she needs to take a vacation overseas, etc.). She does not pay off any of the balance by the end of the year and she actually ends up borrowing $1000 at the beginning of year two. She pays off the entire balance in one payment at the end of year three.[183] The consumer therefore carries an average balance of $1000 in year one and $2000 in years two and three.

Now consider two credit card contracts. The first (Contract 1) offers a flat APR of ten percent with no introductory rate. The second (Contract 2) has a teaser rate structure consisting of zero percent interest for one year and thirty percent interest after the end of the introductory period. The consumer's perceived cost of Contract 1 at the time she decides upon the credit card contract is $100 ($1000 x 10% APR x 1 year). The consumer's perceived cost of Contract 2 is $0 ($1000 x 0% APR x 1 year). The present-biased consumer will always choose Contract 2 with the teaser rate. However, the ex post borrowing patterns of this consumer show that Contract 1 should have been the preferred choice. The actual cost of the credit card with the teaser rate to this consumer will be $1200 ($2000 x 30% APR x 2 years). The cost to the consumer for Contract 1 would have been $500 [($1000 x 1 year + $2000 x 2 years) x 10% APR].

The information above advances a plausible theory about how teaser rates exploit a known consumer bias. I will now address two related empirical questions: do consumers systematically misunderstand deferred costs, as in the example above, and do issuers employ contractual terms that exploit those biases to the detriment of consumer welfare?

D. Empirical Evidence from Credit Card Markets

The preceding section presented evidence that consumers exhibit time-inconsistent preferences in a number of contexts that might be relevant to credit card borrowing. However, we should question the external validity of this evidence before jumping to the conclusion that this phenomenon distorts credit card markets. Even if individuals display behavioral biases in other contexts, they may not show the same biases in the credit card context. This following section supports the

183. For the sake of simplicity, this example ignores the complexities of minimum monthly payments, an assumption that exaggerates the amount of interest that would actually be paid under both contracts.

conclusion that consumers misunderstand teaser rates to their detriment by presenting empirical evidence from credit card markets.

1. *Direct Evidence that Consumers Misunderstand Teaser Rates to Their Detriment*

Advancing the proposition that consumers misunderstand teaser rates implies several testable hypotheses. First, that consumers prefer credit cards with the low introductory rates over credit cards with higher introductory rates or no introductory rate at all, even though ex post borrowing patterns would reveal that consumers would have paid less total money for the credit card if they had acted on the opposite preference (prediction one). Second, that if consumers misunderstand teaser rates to their detriment, then consumers with low introductory rates borrow more money than similarly situated consumers with higher introductory rates or no special introductory rates at all (prediction two). Third, that one might expect the former, low-introductory-rate group to pay more total interest than the latter, high-or-no-introductory-rate group (prediction three). Finally, that consumers will be more responsive to changes in the more salient introductory rate than to changes in the less salient post-introductory rate (prediction four).

These predictions can be evaluated with results from a controlled randomized trial conducted by a credit card issuer in 1995.[184] The issuer in the study randomized 600,000 potential new customers to experimental groups and gave each group different credit card teaser rate structures, but kept all other characteristics of the offer identical.[185] Because the groups were randomized, differences between the groups in the amounts borrowed and interest paid may be attributed to the variation in the teaser rate structure.

Based on ex post data on the borrowing and repayment patterns of the consumers in the experiment, those consumers who chose the offer associated with the 4.9% introductory rate for six months on average paid $50 more in interest charges than those consumers with an offer that was identical except for the 7.9% introductory rate for twelve months—or a two percent greater effective interest rate.[186] The same results held even when there was a less dramatic difference in

184. *See* Shui & Ausubel, *supra* note 147, at 7.

185. The study included four groups with interest rates of 4.9%, 5.9%, 6.9% or 7.9% for six months, a group of 6.9% for nine months, and a group of 7.9% for twelve months. All six groups had a post-introductory rate of approximately 16%. *Id.* at 2, 7.

186. Shui & Ausubel, *supra* note 147, at 9. The effective interest rate is the annual interest rate respondents actually pay in each market cell or the ratio of total interest payments to total debt.

the introductory interest rates. Consumers in the group offered a 4.9% introductory rate for six months paid more in interest than those offered a 6.9% interest rate for a period of nine months.[187] The data show that consumers in these groups would have been better off had they chosen the *higher* introductory rate.

The most persuasive explanation of the mechanism through which the teaser rates induced higher interest payments was that consumers did not understand the costs associated with the post-introductory rate borrowing. In responding to credit card solicitations, consumers preferred the offer with the 4.9% introductory rate for six months to an otherwise identical offer with an introductory rate of 7.9% over twelve months. The consumer preference is puzzling since the consumers who chose the less-preferred offers also paid less in interest—a phenomenon the authors of the study label "rank reversal."[188] Moreover, if consumers understood the prices in the market, the natural prediction would be that consumers would switch credit cards frequently, rolling over their debt to new cards with zero percent introductory rates.[189] However, Shui and Ausubel find that consumer switching behavior is not consistent over time.[190] The majority of respondents stay with their credit card after the introductory period, and their debts remain at the same level as when they accepted the card.[191]

The experiment shows that consumers do not have trouble evaluating APRs relative to each other,[192] but rather that the variation in the duration of the introductory period leads to the phenomenon of rank reversal. These results are also consistent with the behavioral theory explanation that long-term prices are non-salient to at least some consumers because they hyperbolically discount future costs and underestimate future borrowing. The experiment strongly corroborates my first prediction.

187. Shui & Ausubel, *supra* note 147, at 36 tbl.2.

188. Shui & Ausubel, *supra* note 147, at 3.

189. *See* Bar-Gill & Warren, *supra* note 25, at 50 ("Assuming that the costs of switching from one credit card to another are small, teaser rates would not be offered by an issuer that faces perfectly rational consumers. These consumers would transfer their balance to a new card with a low teaser rate as soon as the old card reverted to the high postintroductory rate.").

190. Shui & Ausubel, *supra* note 147, at 3. The existence of switching costs may explain the observed reluctance of consumers to switch cards. *See supra* notes 146–47 and accompanying text.

191. Shui & Ausubel, *supra* note 144, at 3.

192. Among the offers with a six-month introductory rate period and other identical characteristics, consumers in the Shui & Ausubel study preferred—in order from most to least—the teaser rate offer with the 4.9% introductory rate, the 5.9% introductory rate, the 6.9% introductory rate, and the 7.9% introductory rate. Shui & Ausubel, *supra* note 147, at 9, 36 tbl.2.

The evidence not only suggests that consumers misunderstand the teaser rate offers they were given, but also suggests that subtle variations in the magnitude of interest rates and the duration of teaser rates directly cause variations in borrowing, late fees, and effective interest rates between the groups. The group with the lowest introductory rate (4.9% for six months) carried a higher revolving balance than one of the groups with a higher introductory rate (the group paying 6.9% for nine months).[193] In addition, the group with the lowest introductory rate had more late payments than one of the groups with a higher introductory rate (the group paying 7.9% for twelve months), and paid higher effective interest rates than both groups with higher introductory rates for longer durations.[194] Since the groups were randomized, the differences can be attributed to the effect of variations in the teaser rate. This finding strongly corroborates my second and third predictions.

The evidence also demonstrates that consumers are more sensitive to changes in the introductory interest rate than to changes in the post-introductory rate. By comparing experimental groups that received different offers, Ausubel constructed the implied demand curves for both short-term rates and long-term rates. The data show that credit card consumers in the study are at least three times as responsive to changes in the introductory interest rate compared to changes in the post-introductory rate.[195] Consumers are also two to three times as responsive to changes in the introductory interest rate as compared to changes in the duration of the term of the introductory rate based on borrowing behavior.[196] These results indicate that the introductory rate is more salient to consumers than the duration of the introductory period. Shui and Ausubel tested the preferences of consumers in the data set and rejected the hypothesis that consumers in the dataset exhibited time-consistent behavior, even when accounting for the possibility of random shocks that generated divergence be-

---

193. Shui & Ausubel, *supra* note 147, at 35 tbl.1.

194. Shui & Ausubel, *supra* note 147, at 36 tbl.2.

195. Ausubel, *supra* note 69, at 21; *see also* Stephan Meier & Charles Sprenger, Evidence on the Effect of Present-Biased Preferences on Credit Card Borrowing 5 (2008) (unpublished manuscript) ("[I]ndividuals borrow more in the present than they actually would prefer to borrow given their long-term objectives.").

196. Ausubel, *supra* note 69, at 22. The value of the duration of the introductory term was assessed by asking how much money the consumer would have saved at his realized amount of borrowing if he had borrowed the same amount under the different introductory term period.

tween the consumers' initial plans when they accepted the credit card and later actions.[197] These results validate my fourth prediction.

My interpretation of the study requires a few caveats. Since the study is a controlled randomized trial, many of the typical concerns of omitted variable bias are not present. However, the experiment only covers limited introductory pricing terms (introductory rates ranging from 4.9–7.9% for a duration of six months to twelve months) during the 1990s. Introductory teaser rates in today's credit card marketplaces span greater variation in introductory rates and in the duration of the introductory period. Notably, sophisticated credit card issuers routinely use randomized trials to determine the profit-maximizing terms of contracts.[198] As a practical matter, the CFPB has the capacity to conduct an updated study on the effects of a broader range of teaser rate structures by requesting the results of other teaser rate market experiments from issuers under its supervisory authority.

Moreover, precise interpretation of results is essential. Consumers may be biased toward certain pricing terms and structures more than others. Other evidence exists suggesting that consumers show relatively less bias when evaluating other credit card pricing terms. For example, another controlled randomized trial evaluated the ability of consumers to make the tradeoff between an annual fee and an elevated APR.[199] The study found that approximately sixty percent of consumers selected the optimal card based on their ex post borrowing patterns.[200] Forty percent is still a significant percentage of consumers who did not choose the optimal contract, suggesting that at least some consumers struggle with the decision between interest rates and annual fees. Consumers in that study were also given the option to change contracts in order to test their ability to learn from mistakes. Very few consumers switched contracts—only six percent of the initial payers of the annual fee and less than one percent of the initial non-payers of the annual fee—even though forty percent of the total borrowers initially chose a suboptimal contract.[201] While this result casts doubt on the ability of consumer learning to correct errors of this type, it is

197. *See* Shui & Ausubel, *supra* note 147, at 25 ("Only by allowing consumers to have time inconsistent preferences . . . can the model prediction match the empirical data.").
198. Shui & Ausubel, *supra* note 147, at 7.
199. Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?* (Fed. Reserve Bank of Chi., Working Paper No. 2006-11, 2006), *available at* https://chicagofed.org/digital_assets/publications/working_papers/2006/wp2006_11.pdf.
200. *Id.* at 4.
201. *Id*. at 12.

notable that the probability of switching increased with the dollar amount of the error in the initial contract decision.[202]

2. *Indirect Evidence that Consumers Exhibit Biases Predicted by the Behavioral Theory in the Credit Card Context*

In addition to the direct evidence described above, there is also indirect evidence that consumers exhibit biases causing them to undervalue the cost of credit cards with teaser rates. I discuss several types of indirect evidence developed in the behavioral law and economics literature in turn.

i. Contract Design

The pricing structure and product design of credit cards might provide evidence that the contract is designed to exploit consumer misunderstanding. The behavioral theory predicts that issuers set low prices for salient, often short-term, costs and higher prices for non-salient, often long-term, prices.[203] If consumers do in fact underestimate their amount of long-term borrowing, the teaser rate is exactly the pricing structure issuers would employ to strategically manipulate consumer misperception. Even if consumers misperceive their long-term borrowing, issuers can predict the actual behavior of consumers across their portfolios because they can use their vast expanse of consumer data from their active accounts. Indeed, the credit card industry has been using psychology to boost revenue and profits for years.[204] Businesses mine data about their customers' behaviors and mispercep-

---

202. *Id.* at 5.

203. BAR-GILL, *supra* note 4, at 52.

204. *See, e.g.*, Charles Duhigg, *What Does Your Credit Card Company Know About You?*, N.Y. TIMES, May 12, 2009, http://www.nytimes.com/2009/05/17/magazine/17credit-t.html?pagewanted=all ("To understand how the credit-card industry got interested in psychology, you have to go way back, to a time when many Americans didn't have a credit card, when . . . the math whizzes arrived. They emphasized that the biggest profits didn't come from people who always paid off their bills but rather from less-responsible clients who never paid their entire balance, and thus could be milked through silently skyrocketing interest rates, late fees and other penalties. Since 1995, the percentage of the industry's income from cardholder fees has more than doubled to 40%. In 2005, as the push to sign up cardholders peaked, the industry sent out more than 10.2 billion credit-card solicitations, which would cover more than the entire world's population. Two years later, card companies collected $40.7 billion in profits before taxes, according to R. K. Hammer, a credit-card advisory firm. Today Americans carry an average of 5.3 all-purpose cards in their wallets, and the average household has $10,679 in credit-card debt, according to the industry publication The Nilson Report.").

tions in order to offer terms and conditions that maximize profits.[205] Industry experts confirm the importance of exploiting consumer biases in setting credit card prices.[206] In contrast, credit unions, entities that have less incentive to make a profit by exploiting their members, offer fewer cost deferral mechanisms in their credit card contracts than other issuers.[207]

ii. *Evidence of Present-Biased Hyperbolic Discounting in Credit Card Markets*

While the literature has yet to test whether present-biased hyperbolic discounting actually *causes* increased credit card debt, Meier and Sprenger conducted a field study and presented evidence that credit card borrowing is highly correlated with present bias.[208] The magnitude of the correlation was large. Individuals in the study who exhibited present-biased preferences were fifteen percentage points more likely than individuals who did not exhibit hyperbolic discounting to have credit card debt.[209] Conditional on borrowing, present-biased individuals borrow twenty-five percent more on average than time-consistent borrowers.[210] The correlation between present-biased hyperbolic discounting and credit card borrowing holds even after controlling for a rich set of observed variables including income,

---

205. Braucher, *Scamming*, *supra* note 59, at 27; *see also* KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 21–22 (discussing the use of datasets on consumer information to prescreen for vulnerability as part of predatory mortgage lending practices).

206. Former Visa consultants David Evans and Richard Schmalensee note that "service fees (such as late fees, over-limit fees, and finance charges on cash advances) provide revenues to issuers but are likely to be largely invisible to most consumers trying to choose between different credit card plans." DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING, at xii, 211, 260 (1999). They further note that credit card issuers have a "view that the overall demand for credit is relatively insensitive to interest rates." *Id.* at 167; *see also Frontline*: *The Card Game* (PBS television broadcast Nov. 24, 2009), *transcript available at* http://www.pbs.org/wgbh/pages/frontline/creditcards/etc/script.html (featuring interview with industry expert Shailesh Mehta noting that credit card pricing was designed so that it would require a "degree of some sort to understand").

207. *See generally* Bubb & Kaufman, *supra* note 179, at 40.

208. Stephan Meier & Charles Sprenger, *Present-Biased Preferences and Credit Card Borrowing*, 2 AM. ECON. J. APPLIED ECON. 193, 193 (2010) (finding that "present-biased individuals are more likely to have credit card debt, and to have significantly higher amounts of credit card debt").

209. *Id.* at 195. The authors first elicited time preferences using incentive choice experiments, then matched those individuals to administrative data on borrowing, including tax data and credit reports.

210. *Id.*

credit constraints, and socio-demographic constraints.[211] Further evidence that consumers act irrationally in some instances by borrowing on credit cards is provided in a study by Gross and Souleles. They find that many consumers pay interest rates on credit card borrowing that is greatly in excess of the return on savings they receive from liquid assets that they simultaneously hold.[212] If consumers make decisions about credit card pricing that are systematically present-biased, they may end up paying more interest on the long-term rate than they estimate at the time they select a credit card.

iii. Evidence of the Use of Non-Salient Pricing in Credit Card Contracts

Two recent studies provide evidence that the credit card industry employs non-salient pricing dimensions.[213] The studies do not speak directly to the question of whether post-introductory rates are non-salient, but the evidence that at least some fees are non-salient, combined with the other evidence presented, suggests that long-term rates might be non-salient to consumers.

Both studies examined restrictions on the ability of issuers to raise interest rates and impose penalty fees due to the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act.[214] Among other limitations, the CARD Act limited the ability of issuers to charge high long-term prices such as over-the-limit fees and late fees. Additionally, the CARD Act required issuers to maintain introductory rates for a minimum of six months—a legislative prohibition consistent with the view that the market for teaser rates may not produce optimal outcomes.[215]

The CARD Act created clear, testable predictions between the behavioral theory and neoclassical theory in the credit card market. If

---

211. *Id.*

212. David B. Gross & Nicholas S. Souleles, *Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data*, 117 Q.J. Econ. 149, 180 (2002) (noting that over ninety percent of people in the data set who carry credit card debt have liquid savings in checking and savings accounts and more than thirty-three perecent of individuals in the data set with a credit card balance have more than one month's income in checking or savings accounts).

213. *See* Bar-Gill & Bubb, *supra* note 11, at 976; Agarwal et al., *supra* note 6.

214. *See* Bar-Gill & Bubb, *supra* note 11, at 969; Agarwal et al., *supra* note 6, at 1. For a synopsis of some of the key regulations resulting from the CARD Act, see *What You Need to Know: New Credit Card Rules Effective August 22*, Fed. Reserve, http://www.federalreserve.gov/consumerinfo/wyntk_creditcardrules.htm (last updated Mar. 11, 2010).

215. For a summary of the most significant CARD Act rules, see Bar-Gill & Bubb, *supra* note 11, at 1017 tbl.1; s*ee also* Agarwal et al., *supra* note 6, at 7–9.

the neoclassical theory more accurately described equilibrium conditions in credit card markets, and consumers did not misunderstand the prices that were limited, then issuers operating at a competitive equilibrium would have to raise non-restricted prices, such as the post-introductory APR, to compensate for the lost revenue from the new regulations. If the behavioral theory is correct that the regulations only restricted non-salient prices, then the regulations might improve market efficiency and result in no offsetting price increases or reductions in overall credit extended to consumers. Both studies produced results that are consistent with a low-salience, high-fee industry that is consistent with the behavioral explanation.

Examining a dataset of credit card contract terms, Bar-Gill and Bubb found no evidence of significant increases in annual fees or purchase APRs in credit card contracts.[216] Moreover, Bar-Gill and Bubb report data showing that in the year following the restrictions on non-salient fees, revenue, asset yield, and profitability in the credit card market drastically declined, indicating that the restrictions on non-salient prices likely shifted producer surplus to consumer surplus.[217]

In a second study, Agarwal et al. analyze a dataset compiled by the Office of the Comptroller of the Currency covering over 150 million credit card accounts—nearly all of the credit card accounts held by the eight largest U.S. banks.[218] The data includes account-level information on contract terms, utilization and payments at the monthly level from January 2008 to December 2012, as well as portfolio-level information from each bank, including items such as operational expenses. Since the dataset covers the period during which CARD Act regulations went into effect, the authors can draw conclusions about their impact on consumer and issuer behavior. The results show a large decline in fees—as expected because of the new regulations—with the largest effect on borrowers with the lowest FICO scores.[219] The results also show interest rates remain essentially flat over the entire period for every FICO group[220]—a result at odds with the neoclassical prediction. The authors find that the results are "fully consistent with the theoretical model and prior evidence on . . . the low salience of fees in the credit card market."[221]

216. Bar-Gill & Bubb, *supra* note 11, at 993–94.
217. *See* Bar-Gill & Bubb, *supra* note 11, at 999–1000.
218. *See* Agarwal et al., *supra* note 6, at 9–10.
219. *See* Agarwal et al., *supra* note 6, at 18.
220. Agarwal et al., *supra* note 6, at 26.
221. Agarwal et al., *supra* note 6, at 57.

Faced with this evidence, advocates for the use of teaser rates might argue that the market mechanism of consumer learning might deal with the problem of consumer misunderstanding. Consumer learning is not an effective market solution in these instances because all of the data presented in the study is cross-sectional and therefore any effects of consumer learning are already built into the results. Moreover, since many imperfectly rational consumers do not even know that they misunderstand teaser rates, there is little reason to believe they will learn from a bias of which they are not aware.[222] Moreover, the information consumers need to become better informed about teaser rates is costly, and it may be rational for consumers to not invest in acquiring it at all.[223]

iv. Evidence for the Sweatbox Model of Lending

Based on the evidence of behavioral biases in credit card markets, the behavioral theory predicts profit-maximizing firms in competitive markets will strategically design contracts to exploit these biases. John Pottow describes the business model that exploits consumer behavioral biases with high back-end prices as the "sweatbox" model of credit card lending.[224] Because high-risk borrowers in the sweatbox are more profitable than low-risk borrowers, the result is that the traditional lending model is flipped on its head. Instead of extending credit to low-risk borrowers who the lender believes will repay, the lender has incentives to extend credit to risky borrowers who are more likely to trip up on the penalties and pay higher interest rates.[225] High default rates are no longer something to be avoided because the harsh penalty terms that increase the likelihood of default are the very terms that are most profitable. High default rates are viewed as a cost of doing business. Triggers for high interest rates, such as a missed payment, are used to activate the sweatbox for consumers who never intended to trigger those high interest rates. The

222. *See* Bar-Gill & Warren, *supra* note 25, at 12 (noting that imperfect rationality may provide one reason for why consumers remain uninformed about dangerous credit products).

223. Bar-Gill & Warren, *supra* note 25, at 13.

224. John A.E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 405, 416. Ronald Mann provides a detailed description of the "sweatbox" business model. Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 384–92.

225. Pottow, *supra* note 224, 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.").

sweatbox model of credit card lending, if employed by issuers, results in undesirable distributional and efficiency effects.

Does the evidence suggest that credit card lenders employ the sweatbox model? The model implies two predictions, both of which are present in data from credit card markets. First, if credit card issuers were employing the sweatbox model of credit card lending, one would expect the most profitable borrowers to be the ones that are most risky. The Office of the Comptroller of the Currency (OCC) data from the Agarwal et al. study show exactly this pattern in striking fashion. Consumers with low FICO scores—below 620—paid nearly forty-four cents per dollar borrowed in interest and fees.[226] According to this analysis, these high-risk consumers generated a net profit of 7.9%—nearly five times greater than the 1.6% profit generated by the average consumer in the dataset.[227] Of course, these stratifications are not coincidental. Either profit-seeking motives or competitive forces are leading credit card companies to offer credit card products that are less expensive to high-risk borrowers and massively costly to low-risk borrowers. On average, credit card issuers lose money by lending to consumers with FICO scores between 660 and 719.[228] These beneficiaries are cross-subsidized by individuals in other FICO groups. Even if credit card borrowing is most valuable to high-risk groups, a business model that cross-subsidizes certain groups of consumers is not efficient. However, the extreme disparities in profitability based on risk should cause policymakers to question whether credit card issuers employ efficient pricing. At first blush, this profit model appears beneficial to credit card issuers, but it is less clearly beneficial to low FICO score consumers. It would be beyond exceptional if this business model turned out to be efficient.

Second, the sweatbox model predicts that credit cards would have certain product features that ratchet up payments when the borrower is in distress. These product features are present, for example, in late payment fees, late payment triggers that increase the APR, and over-the-limit fees. The retroactive post-introductory rate in the contracts at issue in the CFPB consent order discussed *supra* is a good example of a non-salient trigger that might activate the sweatbox.[229] Moreover, the non-salient pricing structure that leads to underestima-

226. Agarwal et al., *supra* note 6, at 47 tbl.3 (showing that issuers collected income from cardholders with FICO scores below 620 equal to 20.6% of average daily balances in interest charges and 23.3% of average daily balances in total fees—a combined income of 43.9% of average daily balances).
227. Agarwal et al., *supra* note 6, at 47 tbl.3.
228. Agarwal et al., *supra* note 6, at 47 tbl.3.
229. *See supra* notes 123–26 and accompanying text.

tion bias by consumers reinforces the profitability of the sweatbox model. Neoclassical theory also predicts some of these product features. If a borrower makes a late payment, then a rational issuer would incorporate this information and raise the interest rate to compensate for the new revealed risk.[230] However, the pricing features, combined with the increasing rate of profiting from high-risk borrowers, raises doubt that the penalty interest rates and fees are intended to compensate for additional revealed risk rather than to exploit behavioral biases.

The evidence clearly establishes that the behavioral theory provides the best explanation for non-salient credit card pricing features such as teaser rates. Specifically, it shows that such features exploit known consumer biases by shifting cost from more salient to less salient pricing features. Moreover, strong indirect evidence and direct empirical evidence exists to show that teaser rates are non-salient to consumers and that issuers strategically design teaser rate pricing structures to exploit this consumer bias. Applying the abusive standard developed in Sections I and II to the facts developed in this Section, the CFPB should have the authority to write a rule prohibiting or regulating teaser rates in credit card markets.

E. Welfare Effects of Teaser Rates

The CFPB is required to consider the costs and benefits of the rulemakings it initiates.[231] While a comprehensive cost-benefit analysis is beyond the scope of this Note, this section sketches the outlines of several important welfare considerations associated with regulating teaser rates.

First, if teaser rates create a behavioral market failure, they will create an inefficient market. If teaser rates create non-salient pricing structures, then the most efficient suppliers may not be supplying the credit, because those suppliers who are best able to appeal to the consumers biases will gain market share, not necessarily those who supply it most efficiently.[232] The evidence for inefficiency in the credit card market is that teaser rates at zero percent are typically priced

---

230. Incorporating the new information on borrower risk into new prices would allow an issuer to prevent cross-subsidization of risky borrowers from low-risk borrowers.

231. 12 U.S.C. § 5512(b)(2)(A)(i) (2013).

232. *See, e.g.*, Bar-Gill & Warren, *supra* note 25, at 109 (“The optimistic consumer who underestimates the risks associated with the product might purchase a product when the benefits do not outweigh the risks. Instead, the underestimating consumer would consider purchasing the product when the benefits outweighed the *perceived* risks.”); BAR-GILL, *supra* note 4, at 98.

below the issuer's marginal cost, while long-term rates are typically priced above the issuer's marginal cost—a pricing structure that would not occur in an efficient market. There is inefficiency on the demand side as well. If at least some consumers misunderstand teaser rates, then they will be paying more for the credit card services than the amount at which they value those services.[233] The distorted competition comes at the expense of consumers. Inefficient credit card contracts reduce the total surplus created by credit card transactions and shift surplus from consumers to issuers.[234]

Second, teaser rates may have undesirable distributional effects if high-risk borrowers subsidize low-risk borrowers.[235] The airline miles, cash-back, and other rewards that are collected by many low-risk consumers are not awarded out of the altruism of the credit card company. For every account on which the credit card issuer loses money, the issuer recoups that amount in increased fees and interest payments from other borrowers.[236] The recipients of the ubiquitous benefits in the credit card industry are cross-subsidized by those borrowers who are paying extra fees and interest.

Finally, teaser rates may lead to undesirable adverse consequences to third parties. Data shows that consumer bankruptcies are tightly correlated with levels of credit card debt.[237] While correlation does not imply causation,[238] high credit card levels leading to financial distress and bankruptcy have severe adverse consequences for the debt-burdened consumer and those closest to her. Among the consequences to third parties are those that the debtor's family and others in her life suffer due to the economic, psychological, and human costs of the bankruptcy process.

Recent theoretical work confirms that if the behavioral theory correctly identifies back-end prices like post-introductory rates as non-

---

233. BAR-GILL, *supra* note 4, at 98.

234. BAR-GILL, *supra* note 4, at 98.

235. *See* BAR-GILL, *supra* note 4, at 100.

236. *See* BAR-GILL, *supra* note 4, at 100 (noting that consumers who benefit from rewards programs are typically not the same consumers who pay penalty fees and default interest rates).

237. Ausubel, *supra* note 69, at 253–54.

238. It is important to note that other factors may be driving both changes in credit card debt and bankruptcy filing, such as the natural business cycle of the economy. *See, e.g.*, *Ausubel, supra* note 69, at 255. Ronald Mann explored the causal connection in more detail. Mann finds that the effect of credit card debt on bankruptcies with a one-year time lag is not significant at the 5% level, but is significant at the 10% level. However, Mann acknowledges that the data he uses raise questions about the validity of his results. *See* RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD 66–67 (2006).

salient, then credit card companies will exploit the consumer bias and create a net welfare reducing market.[239] Assuming non-salient back-end prices, in the competitive equilibrium credit card firms offer "seemingly cheap credit" but introduce "large penalties for falling behind the front-loaded repayment schedule."[240] Firms design credit card contracts "so that borrowers who underestimate their taste for immediate gratification both pay the penalties and repay in an ex ante, suboptimal, back-loaded manner more often than they predict or prefer."[241] Additionally, "to make matters worse, the same misprediction leads nonsophisticated consumers to underestimate the cost of credit and borrow too much."[242] Heidhues and Köszegi find that the welfare implications are typically large, even if consumer misprediction is small, and that regulations limiting fees on credit cards can improve welfare.[243]

Moreover, a recent article by Bar-Gill confirms that price caps in multi-price markets where prices are designed to exploit consumer biases—such as credit card markets—may be welfare-enhancing by improving efficiency.[244] The key questions are whether the prices to be capped are efficient and salient.[245] If the price is non-salient and designed to exploit consumer biases, then a price cap may improve efficiency, increase welfare, and benefit consumers.[246]

The evidence presented strongly suggests that credit card teaser rates are a pricing structure that only exist because of a behavioral market failure. Prohibiting credit card teaser rates as abusive acts or practices in credit markets would most likely make credit card markets more efficient while significantly improving consumer welfare. Since issuers disclose teaser rates up-front and do not otherwise use fraud or deception in selling credit cards with teaser rates, consumer protection regulators had no authority prior to Dodd-Frank to prohibit teaser rates. Based on the interpretation of the abuse authority advanced in this Note, Congress endowed the CFPB with the authority to regulate teaser rates as abusive acts and practices, and the CFPB should do so

---

239. Heidhues & Köszegi, *supra* note 176, at 2280 ("[W]elfare implications are typically large even if borrowers mispredict their taste for immediate gratification by only a little bit and firms observe neither borrowers' preferences nor their beliefs.").

240. Heidhues & Köszegi, *supra* note 176, at 2280.

241. Heidhues & Köszegi, *supra* note 176, at 2280.

242. Heidhues & Köszegi, *supra* note 176, at 2280.

243. Heidhues & Köszegi, *supra* note 176, at 2280.

244. *See* Oren Bar-Gill, Price Caps in Multi-Price Markets 1–2 (unpublished manuscript) (Mar. 15, 2013), *available at* http://www.law.yale.edu/documents/pdf/LEO/Bar-Gill_PriceCaps.pdf.

245. *Id.*

246. *Id.*

if it decides that regulating teaser rates furthers its mission to protect consumers.

Conclusion

Until now, the academic literature and federal regulators have not recognized or acknowledged that Congress granted the CFPB the authority to address directly problems of consumer misunderstanding and incapacity in consumer financial marketplaces. The abuse standard allows the CFPB to take any action authorized to prevent a covered person or service provider from committing or engaging in an abusive act or practice in connection with any transaction with a consumer for a consumer financial product or service. The statutory language defines abusive acts and practices in terms of the problems of imperfect rationality, as identified in the behavioral economics literature. This Note suggested that an abusive act or practice is one that has the effect of exploiting a known consumer bias and that thereby creates consumer harm, and that has no legitimate and legally cognizable business justification that cannot be achieved in any other manner without exploiting a consumer bias.

Smart application of the abuse standard to the consumer financial marketplace holds the potential for large welfare gains. Effective enforcement of the abuse standard would make consumers better off, remove externalities, eliminate market distortions, and eliminate troubling distributional effects in which lower-income individuals subsidize the use of credit products by higher-income individuals. There may be positive systemic effects as well. If the abuse standard had been vigorously enforced, it might have prohibited the practices in the mortgage industry that led to the originate-to-distribute model, and lessened the impact of the financial crisis in the United States.

This Note examined the question of whether the abuse standard applies to credit card teaser rates. However, the abuse standard may have pervasive applications in broader consumer credit markets. The analytical framework developed here suggests a research agenda designed to identify and describe specific acts and practices that take unreasonable advantage of consumers' lack of understanding or inability to protect their own interests. Acts and practices of this nature almost certainly exist in other major consumer credit markets including mortgage, short-term small-dollar, student lending, auto lending, and other markets. Eliminating these types of abusive acts and practices will not only advance the consumer protection aims of Dodd-Frank, but also will make consumer financial marketplaces more fair and efficient for all participants.