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Consumer Credit and Competition: The Puzzle of Competitive Credit Markets

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Consumer credit markets in the United States present a puzzle. As competing explanations are offered for the recent subprime mortgage crisis and skyrocketing default rates for unsecured consumer credit,[1] two seemingly inconsistent facts confound the discussion. While consumer credit markets are, by all accounts, competitive, consumers find themselves saddled with unsustainable amounts of debt that accrues interest at rates that are borderline usurious. How could these two situations exist simultaneously? It is an article of antitrust faith that competitive markets are good for consumers. In a world of competitive markets, there is a limited role for consumer protection. So long as products are transparent, then consumer preferences, price competition and the invisible hand should produce market nirvana.

Coexisting with this puzzle are competing market-failure based explanations for the consumer credit crisis. Some of these explanations focus on the "supply-side." In the market for home mortgages, the shift from a face-to-face, bank-based, invest-and-hold model of mortgage origination, to a capital markets financed model where mortgage brokers originate mortgages for sale to securitization pools is blamed for creating conflicts of interest between investors and underwriters that inflated an investment bubble. Other explanations focus on the "demand side." Irresponsible consumers are accused of, en masse, borrowing beyond their means and endangering the safety and soundness of financial markets one McMansion at a time.

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[1] In the second quarter of 2009, the charge off rates for credit cards and commercial mortgages were the highest seen since such data has been kept. Federal Reserve Statistical Release, *Chargeoff and Delinquency Rates on Loans and Leases at Commercial Banks* (available at: http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm). Historically, residential mortgage charge-off rates have hovered well below 0.25%. In the second quarter of 2009, the chargeoff rate was a shocking 2.34%. Similarly, the consumer credit card charge-off rate, generally between 4 and 6% over the last ten years, is currently at 9.55%. *Id.*

The post-mortem has led to conflicting prescriptions: (1) do nothing and let the market correct itself; (2) regulate the supply-side for conflicts of interest and transparency; (3) regulate the demand side for transparency; (4) regulate the demand side by prescribing and proscribing certain loan terms. The meme of "competitive credit markets" is frequently interposed, however, to argue for the first option over the other, more intrusive, and nominally anti-market options of either market regulation or consumer protection. In this essay we seek to add nuance to the competition story, and seek, in the process to propose a comprehensive regulatory architecture for consumer credit that uses the dynamics of competition constructively to channel behavior of mortgage underwriters, regulators and consumers.

In order to untangle the relationship between competition and consumer credit, one must recognize that there are really four "competition" stories that need to be understood. The first is the standard competition story between and among lenders for customers. The second is competition between and among lending technologies driven by regulatory arbitrage. The third is competition based on product innovation and differentiation, and the fourth is competition among regulators. Each of these "competition" stories offers a distinct set of lessons for those who would try to reform consumer credit markets. Without understanding each of the four stories, and the interrelationship among them, reform is likely to miss the mark.

In this short essay, we will seek to sketch the paradox of competition and consumer protection. Then we will sketch out each of the four competition stories, some potential competitive benefits, and respective market pathologies of each. Next, we will evaluate a number of pending regulatory reforms in light of these concerns. Finally, and time permitting, we will suggest the outlines of a coordinated regulatory architecture that seeks to channel the various "competitions" in productive directions, without unduly stifling those competitive efforts. Given the space (and time) constraints involved, much will have to be fleshed out during conversations at the Antitrust Marathon.

I. Competition and Consumer Protection: The Puzzle

Consumer credit markets changed fundamentally after about 1980 with the development of a secondary market for home mortgages and the ability of credit card issuing banks to securitize their credit card receivables. The changes accelerated through the 1990s, and the freight train went off the rails in 2008 and 2009. Prior to the advent of securitization, savings and loans issued home mortgages for their own account, and revolving consumer credit was in its infancy. Economists predicted that lender risk aversion, coupled with the inability to price discriminate between high risk and low risk borrowers would lead to credit constraint. In such an environment, consumer protection had little role. In a world where consumer credit was undersupplied, underwriting standards did an imperfect, but probably overzealous, job of protecting consumers.

After 1980, however, everything changed. First, credit reporting made it possible for national lenders to determine the creditworthiness of borrowers on a local level and price loans accordingly. Second, the ability to securitize loans made it possible for lenders to engage in risk based pricing, and match the risk attributes of loans to the risk preferences of investors. As such a market emerged for issuing credit to riskier customers.

So far the story is all positive. Changes in lending technology eliminated a market imperfection. This improvement in the market for consumer credit had a second order effect, however, that may have been unanticipated. Consumers without experience managing credit had access to credit in unanticipated amounts. The greater riskiness of these borrowers led unsurprisingly to increases in consumer defaults. Again, so long as this risk is properly priced, the market for consumer credit will increase consumer welfare, albeit with a higher level of default.

As we have explored elsewhere, however, the unalloyed welfare enhancement story breaks down if one has concerns about consumer rationality, and we do. Cognitive psychologists and researchers into behavioral decisonmaking have raised serious doubts about the ability of many consumers to make rational decisions about consumer credit. These doubts arise from cognitive limitations of consumers, many of whom have difficulty comparing or understanding basic loan terms, from heuristic biases, such as optimism bias and endowment effects, and from time-inconsistent preferences, sometimes referred to as hyperbolic discounting. Many consumers are not particularly good at maximizing their preferences where credit is involved. Indeed, confusion about consumer credit distorts consumption decisions as well as borrowing decisions. To make matters worse, these cognitive and heuristic biases are well understood by lenders, who use teaser rates, back end fees, and balloon payments to hide the true cost of loans.

This disconnect between consumer decisionmaking and consumer preferences goes part way toward untangling the puzzle of competitive credit markets and the need for consumer protection. While lenders do not want to "sell" more credit than borrowers can repay, they may very well wish to sell more credit than the consumer would want or need if they truly understood its costs. As such, competitive credit markets may not be welfare maximizing.

II. Consumer Credit and Competition

But consumer error is not the only culprit. In this section, we will identify four distinct ways in which competition plays a role in the market for consumer credit, and how it influences the shape of potential consumer protection. We will seek to identify the competitive benefits and pathologies that exist in the market for consumer credit, and are looking forward to a discussion that develops these further.

A. Price and Terms Competition

As noted above, the market for consumer credit is generally believed to be competitive. Lenders make a profit, but the profit does not appear to be "supernormal." Indeed, even though the costs of subprime loans are often shockingly high, subprime lenders do not appear to earn a higher rate of return than prime lenders. The costs of administering subprime loans, along with higher default rates eliminate much of the benefit associated with what appears to be "price gouging." However, for the reasons described above, the fact that the market is competitive does not mean that it is welfare maximizing. Indeed the problems in consumer decisionmaking suggest that the market for consumer credit may create a variety of "lemons equilibria."

The first "lemon" is the most surprising. Price competition is usually thought to be immune from "lemons" problems. Consumers understand price, and they usually understand what the product is that they are buying. This is often not the case with consumer credit. Price competition often takes the form of price concealment. Worse yet, competing on the basis of price and transparency is a truly bad marketing strategy where selling your product turns on concealing its true costs.

The second "lemon" is, not surprisingly, the market for non-price terms in consumer credit. However, those "non-price" terms are often where the true cost of the loan lie. Default interest rates, universal default terms, prepayment penalties, events that terminate favorable teaser rates, and so on are all related to the "price" of the loan, but they are not presented as part of the principal amount, the term or the interest rate. For some loans, this is fair, and the default terms are truly held in reserve for non-payment. However, for many consumer loans, the default rates, late fees and penalties are part of the business model, and where the real profit lies. Because these terms are both non-transparent, and designed to capitalize on consumer heuristic biases, it is unlikely that competition will, by itself lead to the elimination of these problematic terms.

Thus, the market for consumer credit while competitive, is not welfare maximizing because of the two "lemons" equilibria described above, or to put it another way, because of the intentional blurring of the line between price and non-price competition.

B. Competition among Lending Technologies: Regulatory Arbitrage and Agency

The second form of competition is the competition among lending technologies. From the depression forward, consumer lending was handled by banks. Mortgages were issued by savings and loans, or by national banks, but were held by the bank for their own account. Banks capital requirements were regulated, and the safety and soundness of the banking system was monitored by the various bank regulators, the FDIC, the OCC, and the Federal Reserve. With the emergence of a

secondary market for home mortgages, the regulatory architecture began to change. The moving of mortgages out of banks and into mortgage pools had the effect of moving mortgage lending out of the more traditional bank regulatory structure.

Initially Fannie and Freddie exercised some control over the shape of the securitization market by limiting the loans with access to the secondary market to prime, conforming loans. Later, however, as a secondary market emerged for subprime and non-conforming loans, the effect of securitization on mortgage terms reversed. It led to a proliferation of products and a proliferation of terms that no were no longer subject to the requirements of either bank regulators, or the standardizing force of Fannie or Freddie. As such, the shift from bank-based mortgage finance was driven, to a certain extent, by regulatory arbitrage. Instead of being regulated by bank regulators for safety and soundness, the new "capital markets" based mechanisms for financing mortgages were regulated by securities regulators solely for disclosure As such, the new "securities" products began their own competitive process of innovation, from RMBS to CDO to CDO-squared, all the way to synthetic CDOs where no mortgages were involved at all. Oddly, the demand side and the supply side did an about face. There was such a strong demand for mortgage backed financial products that the supply of "mortgages" could not keep up with the demand.

This change of lending technologies had the result of creating a number of agency problems. One set appeared at the originator stage, where originators would choose which mortgages to keep for their own account and which to sell to the secondary market. A second set of agency problems appeared with regard to the gatekeepers -- appraisers, underwriters and rating agencies -- all of which were compensated based on volume of deals rather than on the success of those deals or the accuracy of their ratings.

These competitive pressures placed increased burdens on two flawed decisionmakers. First, consumers were faced with a plethora of products, sold, in various ways, as providing them with access to the American Dream (be it a house or flat screen TV). Second, investors were presented with a plethora of non-transparent mortgage backed investment products that were sold as "investment grade," when it is now, by no means clear that the ratings agencies understood, in any meaningful way, how to assess the risk of these complex financial products. On both the consumer lending side and the capital markets side, the institutions that were "selling" consumer credit were competing for suckers (including home buyers about to start a family, and grandparents hoping to be able to augment their retirement nest egg).

C. Competition through Product Development

Another aspect of the market for consumer credit has been the development of new financial products. Prior to 1980, there were a limited number of plain vanilla mortgage products. 30 year and 15 year fixed rate mortgages, and perhaps an

adjustable rate mortgage. Even during the initial stages of the development of mortgage securitization the secondary market for home mortgages was controlled by Fannie Mae and Freddie Mac. Access to the securitization market was limited to so called "plain vanilla" prime mortgages, and so, at least initially, the development of mortgage backed securities actually operated to regulate the terms of most small to mid sized consumer mortgages.

As the RMBS market moved beyond the prime mortgages that Fannie and Freddie could purchase, new, exotic products began to emerge. High loan to value mortgages, ARMs with teaser rates or balloons, home equity loans, used to consolidate credit card debt, proliferated. On one hand, these product innovations provided many options to consumer borrowers. On the other hand, they may have created the opportunity for confusion and deception that has led to the crisis of overleverage we currently face.

C. Regulatory Competition

The final competition story is one of regulatory competition. Regulation of consumer credit is currently quite decentralized. Different pieces of the consumer credit market are regulated, respectively, by the Federal Reserve, the OCC, the FTC, the FDIC, the SEC, and cognate state regulators. Each of these regulators has concurrent responsibility for a different piece of the consumer credit market, and none has primary responsibility. The banking regulators are focused principally on the safety and soundness of the banking system, while the SEC is focused principally on protecting those who invest in either shares of banks or in asset backed securities. Only the FTC has consumer protection as part of its central mission, but it has no particular expertise in or responsibility for financial instruments. This balkanization of regulation has led Elizabeth Warren and Oren Bar-Gill to propose a single, centralized, Consumer Financial Products Safety Commission (discussed below). We see considerable advantages to such an agency, but we also recognize that there are considerable advantages to a decentralized regulatory architecture. Multiple agencies are harder to capture. Multiple agencies can divide up tasks according to comparative competencies. Mutiple agencies can provide multiple poles in a policy debate, and can spur or retard regulation. On the other hand, it may also lead to lack of coordination. The effects of regulatory competition are ambiguous. They can lead to cooperation, or to conflicting mandates, and coordination problems.

III. Towards a Coordinated Regulatory Architecture

So, we are faced with two failed markets – the demand for consumer credit and the institutions for supplying it, and four stories of imperfectly channeled competition. The puzzle of consumer protection, therefore requires an approach to regulation that simultaneously recognizes both the limitations of consumers, the realities of consumer lending and the limits of lending institutions. Protecting consumers on

the demand side must be done in a way that is sensitive to its effects on the supply side.

With that in mind, it is useful to identify the key problems identified above:

1) consumer cognitive limitations and heuristic biases (consumer protection).
2) the conflicts of interest that arise between loan originators and securities purchasers as a result of the shift from face to face lending to capital markets financing (investor protection).
3) the need for coordination among regulators (regulatory competition and coordination).

At the same time, securitization is not going away, so the realities of the capital markets require products that can be standardized and pooled.

Each of these problems suggests an attribute of the regulatory architecture that we propose. First, there must be regulation of the terms of consumer loans that encourage transparency, and, more importantly comprehension of loan terms and loan consequences. Second, many of our concerns about complexity and moral hazard are alleviated when a lender is lending face to face, with the expectation that they will hold the loan to term. Third, regulation of consumer credit requires more than regulation of loan terms and products. It also implicates the safety and soundness of the banking system and the integrity of the securities markets.

IV. Evaluating Current Reform Proposals

A brief evaluation of the various reform proposals that are currently on the table simultaneously shows the risks of a non-coordinated approach, and suggests some of the attributes of a coordinated architecture. The two major proposals on the table are (1) the "Miller Bill"[2] that proposes an "appropriateness" standard for consumer loans, and would give the borrower a defense if the loan was deemed unsuitable: and (2) the proposal for a Consumer Financial Products Safety Commission. In addition, for comparison purposes it is worth taking a look at the manner in which the UK has regulated consumer loans.

First, the Miller Bill suggests that mortgage originators should be subject to liability and borrowers should have a defense to payment where it can be shown that the lender originated an "inappropriate" loan. Appropriateness is measured by reference to the borrower's ability to pay, and also with regard to the interest rate and housing market risks embodied in the loan through rate adjustments, balloon payments and/or prepayment penalties. The problems that such an appropriateness requirement addresses are real, but to the extent that it uses a

[2] Mortgage Reform and Anti-Predatory Lending Act, H.R. 1728 (available at: http://thomas.loc.gov/cgi-bin/query/D?c111:4:./temp/~c111z8T3DZ::)

"standard" to impose liability, there is considerable worry about the effect that such a requirement might have on the ability of originators to securitize their loans.

Second, there is a pending proposal for the creation of a Consumer Financial Products Safety Commission that would pass on the safety of financial products.[3] The Consumer Financial Products Agency Act would transfer enforcement authority and rule making authority under a wide variety of consumer lending statutes, to this new agency. There is a lot to recommend such an idea. In particular, through its rulemaking authority, the new agency could generate safe harbors and sustainability requirements that were both more specific and more flexible than those written into a statute like the Miller Bill. However, it also raises some concerns. First, to the extent that it sets out particularized limitations on the forms that loans might take, it may stifle innovation. Second, to the extent that it is granted exclusive jurisdiction over consumer financial instruments, it may be subject to capture.

Third, in evaluating these two proposals, it may be worth taking a look at the UK experience, where they have an existing architecture involving standards based regulation of consumer finance, managed by a single regulator. As we have discussed elsewhere, the UK consumer lending markets have functioned well, notwithstanding an appropriateness standard that lacked the safe harbors contained in the Miller Bill. Indeed, while UK investors have suffered because of their exposure to the US subprime market, the UK has not had a similar subprime crisis involving its own citizens.[4]

V. Knitting the Proposals Together

In our view the regulation of consumer credit transactions requires a merging of each the three approaches embodied in the pending regulatory reforms. First, what is needed is a mix of standard based regulation and safe harbors. The "appropriateness" standard of the Miller Bill represents a suitable default. Lenders should take care not to saddle borrowers with unsustainable debt, and where they do, borrowers have reason to complain.

At the same time, the possibility of an "appropriateness" defense will render most loans unsecuritizable. As such this would significantly raise the cost of consumer credit, and this is not desirable In our view, therefore, to the extent that there are well understood transparent and straightforward loan products, and basic documentation requirements, many consumer loans could be subject to an appropriateness safe harbor, and therefore available for securitization. By contrast

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[3] The proposed text of the Consumer Financial Protection Agency Act, H.R. 3126 (introduced 7/8/09), is available at: http://www.financialstability.gov/docs/CFPA-Act.pdf, or at http://www.thomas.gov/cgi-bin/query/z?c111:H.R.3126:.

[4] Susan Block-Lieb and Edward J. Janger, *A Comparative Look at Responses to the Mortgage Crises in the US and UK* (manuscript on file with authors).

non-standard loans would be subject to a more amorphous appropriateness standard. Such loans would not be forbidden, but the lenders would not be able to sell the loans to the aftermarket, and would have to hold them for their own account.

A key role of any proposed regulator would be to define the terms and establish the outlines of these safe harbors. As such, the two pending proposals might work better in tandem than standing alone. Finally, it seems to us that it is crucial that the jurisdiction of any proposed financial services regulator would be concurrent rather than exclusive. Risks of capture are significant where consumer protection is concerned, so a decentralized approach is probably preferable.

Conclusion

The observations and conclusions contained in this essay are obviously quite tentative, and the competition stories, in particular, are not fully or rigorously developed. Much of the discussion about consumer credit has involved advocates of consumer protection talking past experts on bank and securities regulation. Competition scholars have played relatively little role, while the meme of competitive credit markets, and the need to preserve competition and innovation have been offered by the financial services industry as reasons to stay the hands of the regulator. We hope that this paper, and the discussion at the Antitrust Marathon will go part way toward adding nuance to this role currently played by "competition" based arguments in the policy discussion.