The impact of consumer finance reforms since the Great Recession

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University of Pennsylvania Law School Professor Natasha Sarin. Credit: University of Pennsylvania

In an important new article, University of Pennsylvania Law School Professor Natasha Sarin deploys original empirical research to examine the impact of key consumer finance reforms implemented in the wake of The Great Recession. "Making Consumer Finance Work," forthcoming in the *Columbia Law Review*, details her findings about the successes and failures of reforms aimed at debit and credit cards and overdraft fees, and offers crucial insights to guide policymakers in future regulatory efforts.

Sarin is an Assistant Professor of Law with a secondary appointment in the Finance Department at the Wharton School. Her teaching and research interests are at the intersection of law and finance, with her recent research focusing on financial regulation.

"The Great Recession was the worst economic downturn in the United States since the Depression," writes Sarin. "More Americans lost their jobs than at any time since World War II.1 Over two million businesses closed their doors because they could not make payroll. Nearly eight million families lost their homes. The average American household lost one-third of its net worth."

In response to the crisis, President Barack Obama created the Consumer Finance Protection Bureau and tasked the agency with better regulating the financial markets to protect consumers. Sarin analyzes three of the most significant reforms to emerge from this period: The Durbin Amendment, which capped debit card interchange fees; the Credit Card Accountability Responsibility and Disclosure ("CARD") Act, which reduced banks' ability to charge hidden credit card fees; and the default rule requiring bank customers to affirmatively opt into overdraft protection.

To conduct a data-driven analysis of the impact of these reforms, Sarin assembled and relied upon a "unique dataset … of effective interchange rates for 120 industries in 40,000 zip codes in the United States (totaling more than ten million observations), branch-level data on checking account fees reported weekly for 58,000 bank branches in the United States, and financial regulatory data reported quarterly by each of the 4,800 bank holding companies in the country." Based on the data, Sarin concludes that while the CARD Act and overdraft fee reforms succeeded in increasing consumer welfare, the Durbin Amendment did not.

Before the Durbin Amendment was passed, when a consumer used a debit card to make a purchase, a merchant would pay the bank 2 percent of the value of the transaction to cover the cost of processing. The Amendment capped these "interchange" fees at 22 cents, with the objective that merchants would pass the savings on to consumers through lower retail prices. Instead, however, Sarin's data shows that "(1) banks increased consumer account fees to recover all lost interchange revenue, and (2) merchants failed to fully pass through their cost savings to consumers." Indeed, she writes, "[p]rices set by supermarkets and convenience stores whose costs fell significantly because of Durbin are virtually indistinguishable from those set by merchants with low (or no) interchange savings," and gas prices fell by only $.004 on average even as gas retailers received more than 15 percent of the total savings from the passage of the Amendment. At the same time, banks sought to recoup the fees by hiding them elsewhere, for example by reducing the availability of free checking accounts.

In contrast, the CARD Act successfully helped to decrease the cost of credit cards for consumers by curtailing banks' freedom to advertise attractive percent initial interest rates and then charge high back-end fees such as penalty fees, interest rate increases, and over-limit fees. By requiring more fulsome disclosures of fees up front, thus reducing banks' ability to hide them from customers, "estimates suggest the CARD Act reduced overall credit card fees by nearly $25 per account annually, resulting in total cost savings for credit card users of nearly $12 billion per year," writes Sarin.

Customers saw similar savings from changes to the structure of overdraft protection. "Prior to recent changes, bank customers were automatically opted in to overdraft protection," Sarin explains. As a result, "[c]onsumers could effectively pay $40 for their morning coffee (coffee plus $35 overdraft fee) by using their debit cards without sufficient funds in their checking accounts." Following implementations of the new rule, which bans automatic enrollment and requires customers to opt in, the share of bank customers opted in to overdraft protection dropped from 100 percent to just 16 percent.

Sarin identifies three key lessons from the successes and failures of regulation post-Recession: First, she notes, if left unchecked, "banks exploit consumers' behavioral limitations—like over-optimism (e.g., consumers' mistaken beliefs that they will never be delinquent in paying credit card bills) and inattention (e.g., consumers' failure to read checking account contracts, which explicitly detail the significant costs of overdrafting)," thus allowing them to charge high hidden fees. "As such, policymakers must bring discipline to these markets by restricting shrouded pricing." Second, "low-income consumers tend to pay higher prices than their high-income counterparts" for banking products, and regulators ought to pursue reforms that reduce such inequality.

Finally, she writes, "regulators should follow what banks do—not what they say. Every time regulators act, banks caution that consumers will be hurt, because affected institutions will have no choice but to pass costs through to consumers." However, as demonstrated by the success of overdraft reform and the CARD Act, "in many instances, impacted institutions eat the losses from regulation, rather than passing them through to their customers." Thus, "being too beholden to how we believe banks will respond to regulation—rather than following the data to understand how banks actually respond to regulation—leads to an overly pessimistic view of regulatory efficacy."

In the decade since the crisis, new risks have begun to emerge in the consumer finance markets, among them student loan balances and the subprime auto loan bubble. To address these new issues, "the success of the reform agenda relies on heeding the lessons learned from the triumphs and failures of past regulatory interventions," writes Sarin. "Only then can we successfully course-correct, where necessary, to best serve consumer interests."

More information: Making Consumer Finance Work, *Columbia Law Review*, Forthcoming. U of Penn, Inst for Law & Econ Research Paper No. 19-07. papers.ssrn.com/sol3/papers.cf … ?abstract_id=3328607

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