Episode 137: Todd Zywicki and Brian Johnson

Speaker 1 (00:04):

Welcome to the Bill Walton Show, featuring conversations with leaders, entrepreneurs, artists, and thinkers. Fresh perspectives on money, culture, politics, and human flourishing. Interesting people, interesting things.

Bill Walton (00:24):

Welcome to the Bill Walton Show, I'm Bill Walton. If you think a show about financial regulation is likely to be boring, I want you to think again. Financial regulations are really about money, and in particular, every Americans money, consumer credit, credit cards, student loans, how your credit gets reported, mortgage finance, getting a mortgage, who gets a mortgage. FinTech, the technology piece of banking that's coming into Vogue now. Cryptocurrencies and increasingly it's not only about consumers, but it's how small businesses get financed. In other words, it's a matter that's vital to tens and tens of millions of Americans.

Where we're going with this today is that financial regulation has become one of the primary battlefields in which the left hopes to fundamentally transform America through the prisms of race and social justice. It's a very interesting battlefield, one that we don't know enough about, and with me to help explore this is Todd Zywicki, who's Professor of Law at George Mason University School of Law, senior fellow at Cato Institute, and recently served as chairman of the Consumer Financial Protection Bureau Task Force on Consumer Financial Law.

And joining me with Todd, you guys are long-term friends. Brian and I worked together. Brian Johnson was deputy director of the Consumer Financial Protection Bureau. He's now partnered Alston and Bird Law Firm, and he was Jeb Hensarling's Chief Banking Counsel for the House Financial Services Committee. Brian, Todd, you both worked together at the wonderful creation of Elizabeth Warren's, which was the Consumer Financial Protection Bureau.

And Todd and I worked, not Todd, Brian and I worked together during the Trump transition laboring long into the night to figure out ways to get rid of it. And instead of getting rid of it, Brian, you ended up as deputy director. We were right involved in the sausage factory. What were you trying to get done there?

Brian Johnson (02:38):

Sure. It's great being here and great to see Todd as well. Let me give you maybe the short history of the CFPB. So folks who aren't kind of in the weeds on what this agency is, what it does, understand it. And then I can discuss where we were circa late 2017 when there was the first leadership transition for the agency in its history. It was a creation of the Dodd-Frank Act, a massive piece of legislation passed on nearly a partisan basis in the aftermath of the financial crisis.

And it was a new agency, a new design, it was designed specifically to be in essence unaccountable to any of the political branches of the federal government. The director is appointed by the president, but once appointed can't be removed except under limited circumstances. The agency's budget is drawn from the federal reserve, not from the US treasury. So Congress by law can't even review the agency's budget. It's intended to be an independent regulatory agency and extremely independent. It had a combination of features that actually got it into trouble with Supreme Court cases challenging the constitutionality of that-

Bill Walton ([03:54](https://www.rev.com/)):

And doesn't it get to set its own budget?

Brian Johnson ([03:56]()):

It does.

Bill Walton ([03:57]()):

I mean, Congress doesn't even approve the budget for this agency.

Brian Johnson ([03:59]()):

No, famously by law, the bureau on a quarterly basis, the director can send a letter. It's usually two paragraphs saying that I've determined that I need $250 million to run the agency for the next quarter. There's a maximum cap established by law, but it's quite generous. And so in the first seven years of the agency's history, it was Democrat control. There was a change obviously in the 2016 election, and then Trump administration came in. And so there was a transition process where director Cordray resigned to pursue other interests. And then there was-

Bill Walton ([04:42]()):

There was Richard Cordray, he left to run for governor of-

Brian Johnson ([04:45]()):

Governor of Ohio.

Bill Walton ([04:46]()):

Ohio.

Brian Johnson ([04:46]()):

Correct. And then there was actually a leadership battle where President Trump attempted to appoint Mick Mulvaney, who was his OMB Director, and CFPB employee who had been tapped at the 11th hour to serve as deputy filed a lawsuit seeking to unseat acting director Mulvaney. That played out over the course of nine months. But in essence, the president was allowed to appoint his preferred acting director.

And so I came in as the first employee under Mick Mulvaney. And what we tried to accomplish there was bring some coherence to the way in which the bureau exercises its authority. It was designed to be extremely independent, it has significant powers over financial markets, and a significant ability to regulate and supervise both banks and non-banks in the financial sector. It's really important if there's little oversight of that agency in how internally it sets internal processes and controls to regulate and govern the use of that authority.

Bill Walton ([05:53]()):

Well, Todd, you've written extensively on financial regulation, the regulatory agencies. I mean, why did we need a new agency? I mean, give me a little history or haven't we already been pretty regulated having a credit card, and banks have... Consumer lending has been pretty regulated. What does that framework look like and why did this new agency need to happen?

Todd Zywicki (06:15):

Need to happen maybe an overstatement.

Bill Walton (06:18):

Well, Elizabeth Warren thought it needs to happen.

Todd Zywicki (06:20):

She did, and I'd been on record of suggesting that maybe would have been better to just allow the federal trade commission to take over a lot of these responsibilities rather than creating a new agency. But I think it is important to understand the historical background to this and sort of where our taskforce came in, which is that the history of consumer credit in the United States really goes back about a century to the beginning of the year of the 20th century, in the early 1900s.

Basically we saw as is people moved into the cities. They left the farms, immigrants came in, what we saw was the first time people needed access to credit to be able to make ends meet, to deal with the vicissitudes of living in the city when you're not growing your own crops or things like that. And for most people what was valuable to them were their wages, because these were penniless farmers, or immigrants who didn't have assets.

And so what happened was they ran smack up against the old Victorian lending laws, strict interest rates ceilings and that sort of thing. And the result was loan sharks proliferated, and millions of people were in hock to illegal lenders who use pretty unsavory tactics to collect their debts. And at the time the idea was, well, let's reform the laws to bring it out in the open, allow competition, and consumer choice, and treat people like grownups.

And so we went through this reform period that allowed access to credit, after the great depression, they cracked down on that again, such that by the 1970s loan sharks were back. According to the United States Senate-

Bill Walton (07:58):

Now what did they cracked down on during the depression?

Todd Zywicki (08:01):

They cracked down access to credit after the great depression, they were restrict-

Bill Walton (08:05):

So the great way to stimulate economy is to cut back on access to credit?

Todd Zywicki (08:08):

Yeah, that's right, that's right.

Bill Walton (08:09):

That would be counterintuitive and wrong.

Todd Zywicki (08:12):

That's right. A lot of people thought the great depression was caused by too much access to consumer credit. According to the 1968 US Senate report, for example, the second largest revenue source of the mafia was loansharking, trailing only illegal gambling. And one estimate by an FBI organized crime expert at the time was that the loansharking racket in the United States at that time was about $10 billion.

And to give you a sense of that, that's about $69 billion in today's dollars. To give you a sense of that, that's about twice the size of the entire payday loan market in America today both online and in person. And so what we learned was consumers need access to credit, that you can wash away the supply, but you can't take away the demand. And so what we saw in the early 1970s, again, was a push for reform, a push for regulation.

And the big thing that happened during that period was the rise of a national consumer finance market driven largely by department stores actually, department store credit was the largest place where people went for credit at that time. And so you had Sears and JC Penny, and these ones who sort of ran these national-

Bill Walton (09:25):

Was there like the layaway plan and-

Todd Zywicki (09:27):

Layaway, early credit cards, all that sort of stuff. Mortgage markets became more national. And so we saw this movement in the '70s towards reform and modernization. And this is when we saw the first great growth of federal regulation in this area on top of state regulations. So we got the Truth and Lending Act, we got some mortgage finance laws, we've got the Equal Credit Opportunity Act, and a lot of other sorts of things. By-

Bill Walton (09:54):

Now, is this mainly federal regulation, or there's also states engaged-

Todd Zywicki (09:59):

Mainly federal.

Bill Walton (10:00):

Mainly federal.

Todd Zywicki (10:01):

And if I had to do with the national market. For example, a good example is debt collection. As the cost of long distance telephone service fell, it became easier to set up sort of phone banks to try to collect debts across state lines, which made it very difficult for states to regulate it. We had a national market, and there was a national commission on consumer finance that was set up at the time that looked at all the laws that our taskforce was modeled on.

2010 as Brian noted, after the financial crisis, we got Dodd-Frank Act creation of the CFPB. And then that's where we became in, which is last year. Brian as deputy director and director Kathy Kraninger gave me the opportunity to come in and lead this task force. And as I think this history says this wasn't a Trump takeover or anything like that, but this was just as the 1970s called forth the need for modernization based on a new national market unlike we're in a completely different world today, it's not a national market.

It's a nowhere market, it's the internet, it's people consume products differently. They use products differently, they get information differently. And so we were tasked to review the existing framework, and come up with ways of modernizing, and reforming consumer financial protection law to deal with the realities of the modern age, in which consumers get credit, access to credit in the like, and sort of review this whole 50 years sort of framework of Ralph Nader version of consumer financial protection, stacked on big stacks of documents that nobody reads-

Bill Walton (11:38):

Well, the working assumption is that every piece of consumer financial protection is a good thing, because consumers are gullible, and don't know what they're doing. And I think in many cases, people find money and I went through a negotiating class, and one of the sessions was on whether you want to negotiate with a credit card company on their fine print. We concluded that that was probably a waste of time. So what-

Brian Johnson (12:10):

And driven by litigation in the first place. The question here's-

Bill Walton (12:14):

There's this paradigm. Oh, continue.

Brian Johnson (12:16):

Sure, you said why was the CFPB necessary? I think the thinking was post-crisis huge problems in the mortgage market, right? Cumulation of risk that folks didn't appreciate or everybody driven figured it out-

Bill Walton (12:30):

But driven by Mr. Dodd and Mr. Frank.

Brian Johnson (12:33):

Right, here's what Dodd-Frank did, and here's what it didn't do. The notion was because the existing federal regulators and there are a lot, so the NCUA for credit unions, OCC, FDIC, FED, all were there and they had a particular-

Bill Walton (12:51):

Now, did those kind of scramble answers.

Brian Johnson (12:54):

Well, it's not easy [crosstalk 00:12:56].

Bill Walton (12:56):

You're watching the Walton Show, and I'm talking here with the Todd Zywicki and Brian Johnson. We're talking about consumer financial protection and the alphabet soup that's presumably protecting us.

Brian Johnson (13:08):

The idea was because it was a fractured regulatory framework, nobody really had their eye on the ball in terms of consumer protection. And because they had a joint mission of ensuring the safety and soundness of institutions, they weren't as focused or were distracted from consumer protection. And so the idea was what's needed is a new agency solely focused on consumer protection without that balanced approach.

And so what Dodd-Frank accomplished was it took authorities from those existing agencies, it shuttered one. and created a new one, and consolidated all of those authorities within one agency focused again, solely on enforcing Federal Consumer Financial Law. What it didn't do was seek to harmonize all of those laws that all of those disparate agencies had already been enforcing. So Todd mentioned a couple of them, the big ones, but the bureau has responsibility for enforcing 18 separate federal laws that had been passed mostly in the '60s and '70s.

Dodd-Frank because it was a crisis, major piece of legislation, but it really passed post-crisis on a fairly accelerated schedule, didn't seek to do the hard legislative work of how do you harmonize all of those 18 laws in a way that makes sense for the modern marketplace. Instead, it just gave responsibility and took it away from the other agencies and gave it to the CFPB and said, "Go figure it out."

That's one of the things that wasn't accomplished, which is still a sticking point for how do we modernize consumer finance regulation? And the purpose again of the task force was 50 years after the original commission. let's take a look at and try and do some of the thinking that wasn't done in the Dodd-Frank Act a decade after Dodd-Frank, with the experience of having grappled with some of the tough issues. How do you integrate, how do you harmonize regulation away [crosstalk 00:15:03] vision?

Bill Walton (15:02):

What's an example of an old law that makes no sense, then what would you do to modernize it?

Brian Johnson (15:08):

Well, I would say in the disclosure realm, these laws were passed in the 1970s. So this was before even a fax machine, everything was paper-based, hand process. We're now in the digital age, what's the best disclosure now for consumer in the context of a consumer finance transaction? Be it a mortgage, or be it a payday loan, or be it a credit card, it's something that's adaptable based off of what an institution knows about that particular consumer, and delivered in real time.

You can do that on a digital basis, and I think there's real opportunity for real-time delivery of meaningful disclosures to consumers that's not the legal ease that you mentioned, where you have 100 pages at a mortgage closing that you have to kind of-

Bill Walton (15:58):

Here's the way I think about all that language. I assume that their lawyers, dozens and thousands of lawyers litigating this day after day, after day, and that language is the product of 100s of legal outcomes. And so I figured they've already people lawyering for me, I don't need to do it myself. Am I-

Todd Zywicki (16:18):

Well, there's this kind of one of these unlikely bedfellows type situations we learned from the task force, which is that there are two groups who adore complex things that can't be understood by ordinary Americans. The first seem to be consumer activists groups, and their allies, and the plaintiff's bar, right? Who seized on every little sort of Corker problem.

A lot of these laws are set up, so you don't even have to show any consumer harm in order to to tote up a bunch of claims and seek statutory damages. My favorite example was a case a few years ago where the electronic Electronic Funds Transfer Act said that banks had to have physical placards on the front of ATM's telling you what the ATM fee was, over time that had replaced by a splash screen that you had to consent to paying the fee.

Plaintiff's lawyers went around town and literally took pictures of ATM's without the placards, and then brought lawsuits, and shook down the industry for millions of dollars for this sort of thing, with no harm shown to any consumer, and a lot of the sort of consumer activist groups, like a lot of these paper-based disclosures and these sorts of things, for reasons I don't fully understand.

But the other one to tell the truth is that the big banks don't mind it either. For the big banks, what they say is just tell us what we have to do. Tell us we don't have to worry about whether consumers can understand it or use it or whatever. Just tell us what we need to do to be covered, just the cost of doing business for them. And there has to be a better way for consumers to actually be able to get the information needed.

Bill Walton (18:04):

Well, it did creates what Jamie Diamond famously calls a moat around their business, which is it's so complex. And there's so many things to comply with that only the very biggest I've got the budgets to withstand all that regulation. If you're a small community bank, and you're asked to do all this disclosure, you can't do it. I mean, you can't keep up with it.

Brian Johnson (18:27):

That's right. It drives concentration, I mean, if you look at the FTC issues, a quarterly banking profile, if you look at that banking profile circa 2007, so pre-crisis, and today, what do you see is the effect of Dodd-Frank and each overlay of regulation, you see they distinguished between banks with less than a billion in assets in banks with over a billion assets. You see that overall, the number of banking institutions has shrunk by 40%, just in the last 14 years.

But the number of institutions with greater than 1 billion in assets has actually increased. And when you look at the total assets held by the concentration of those larger banks, it's doubled roughly in the last 14 years. You do see that the trend and it's in part long-term, but I think is accelerating. The trend is towards a greater and greater concentration-

Bill Walton (19:27):

Or the magnitude don't five biggest banks as something like 60, 70% of all the... My numbers are dated, but it's some enormous here.

Brian Johnson (19:35):

Significant portion of assets and deposits, both assets and liabilities in the banking sector are concentrated at a high level, right? And to your point, they have the economies of scale to deal with the complexity of regulations. If you're looking at a community bank with maybe one branch, there's not a team of compliance professionals there waiting to update compliance management systems for-

Bill Walton (20:00):

Well, lets get to that part I was talking about in my introduction about the sort of this regulatory defacto attack on small business. Dodd-Frank put a motor on the big banks, made them bigger, protected them, they can afford all this regulation, community banks can't, community banks who are one of the primary sources of credit would be startup and small businesses.

Todd Zywicki (20:21):

That's right Billy. Incredibly important point that-

Bill Walton (20:24):

And last time I counted, it was about two or three years ago. There've been like one community bank that's been started since Dodd-Frank. Is that still pretty much the-

Brian Johnson (20:33):

That was I think accurate up until 2017, and there have been new charters granted. I'd say the other major effect I've seen-

Bill Walton (20:39):

Like three?

Brian Johnson (20:40):

Yeah. Look, the large institutions play an incredibly important and increasingly role in the financial system and the broader economy. The other effect that we're seeing, which is the overlay of international bank regulation as well, which accelerated through Dodd-Frank and after is there are now asset classes because of the regulation laid on top of banking institutions that are no longer profitable undertake.

So you're seeing the movement and transfer of assets out of the banking system into the non-bank realm, just because banks can't profitably do it anymore. You see mortgage servicing has nearly moved out of banking institutions. And the question that's never asked by regulators is, have we gone too far? In other words, if banks are just exiting markets altogether, and they're being taken up by state regulated institutions, or other institutions, have we gone too far here?

And the answer is not that, the answer is we need more regulation on the folks who are outside the banking system. And so the majority of is the shadow banking system. And the idea is we need now new bank regulations on the non-banks, including for instance, in under contemplation, presumably by CFPB the imposition of capital and liquidity regulations on non-banks.

And we saw calls for that during the pandemic for mortgage servicers, and now CSBS and state banking regulators are actively working on that. They don't hold deposits, taxpayers aren't on the hook if those institutions fail, nonetheless, the prudential safety and soundness approach to banking regulation is now being imported over to non-banks.

Bill Walton (22:26):

The regulators saw these businesses leaving the big banks and they thought there's a culprit here. And they never looked in the mirror.

Todd Zywicki (22:36):

The latest of course, Brian is Community Reinvestment Act has been floated in the past week to apply to that.

Brian Johnson (22:41):

Part of it is the slow accumulation and aggregation of regs. So you can't really point to one single regulation that's come out in say the last 10 years that is driving all of this, but it's the slow accretion of regulation that has a large cumulative effect. Any individual regulator who's pushing out that one reg won't really bear the brunt of being blamed, I think by history for a significant change.

But again, the collective action from multiple regulators at a federal level over time has had this effect. And we're able to understand those trends. The question is, what do you do as a policy matter? Do you rethink the overall approach of regulation? It seems to be that it's a one-way ratchet and is inexorably going in one direction.

Bill Walton (23:31):

And it's been a one-way ratchet regardless of the administration. I mean, it was a ratchet during both Bush administrations. You get Republicans and I think Trump rolled some of it back, didn't he?

Todd Zywicki (23:43):

I think that's accurate Bill. And I think this point that Brian makes is really important, which is most people don't understand the way in which... They just think of the banks is that regulation out there on wall street, right? But they don't think about this point if the way in which money is energy, right? Money is what we need to live. Access to financial services is what we need to live.

The financial assistance they works pretty well for most middle-class families. We get access to good products, and competitive markets with good players, but there's a lot of people who've been left out, right? There is still a big chunk of Americans who are excluded from the financial system, and regulation can make a much more difficult for them.

And Brian, I think hit on a very important point, and we can come back to this, but one of the ways that this does is the great legacy of Dodd-Frank it has been to promote consolidation in every single industry it has touched, whether it's mortgages, or credit cards, or banks, or whatever. And a lot of it has to do partly, I've been traveling as country for 10 years talking about Dodd-Frank. And I could tell you I've talked to thousands of people, and Dodd-Frank was supposed to do one thing, which is get rid of too big to fail.

I've asked thousands of Americans, whether they think Dodd-Frank got rid of too big to fail. And I have not found a single person who thinks that Dodd-Frank governed too big to fail. Think about that, 2,400 pages of legislation, tens of thousands of pages of regulations, tens of billions of dollars of regulatory costs. In Dodd-Frank, nobody believes that the one thing it was supposed to do, what did it do?

It consolidated every industry it touched, it raised regulatory costs. And so is a real consequences to your point Bill, which is small banks in America do most of the agriculture lending, they do most of the small business lending, they provide the banking services in small town, or rural communities. The big banks aren't interested in making a farm loan in a small town in Iowa, or a small business loan for a strip mall in some rural community.

And so we focused a lot in recent years on financial services, and for minorities and like, but one of the real crisis in this country right now that we learned on the task force is, financial inclusion for rural Americans is a big problem. And it's getting bigger. Banks are closing in small towns, internet service is not as available, so it's not as easy to substitute online banking services.

And it's a problem people haven't really focused on, because it's just not an interesting thing to sort of the inside, the Beltway media in the light who never venture out into Indiana, or Iowa, or North Dakota.

Bill Walton (26:33):

Well, our place is in Rappahannock County, Virginia, and we had some small banks there and they've been community banks. And now they've been absorbed into larger institutions, which were absorbed by still larger institutions. And now you go into your local banker, and there's a teller maybe, but there's no loan officer, there's nobody there who you know. And so you asked for... I've heard people who've gone in there and they say, they're given a computer form they're supposed to fill out, and talk with the people in New York.

Brian Johnson (27:04):

Right, and that's a direct consequence of the current regulatory environment. There's no more relationship lending. It used to be, you would walk into your community bank, you knew the head of the bank because you went to church with them. And they knew you, and they knew whether or not you were a credit risk or not. And right now the movement has been away from that, away from relationship lending, because the regulations are making you check the box in very specific ways as an institution at risk of potential liability over say, the course of a 30 year mortgage.

And so the institutions are being very careful about checking those boxes. And what it means is everybody is reduced not from a person who has a relationship where you can with a handshake make a commitment to that person. But instead essentially a commodity, and the more all of these product requirements are prescriptive and very specific, the less ability there is to deviate. And what that means is, every mortgage looks the same, and if every mortgage looks the same, who's going to be more efficient at doing it? Is it going to be a large institution or a small institution?

Bill Walton (28:15):

Well, I was a banker, commercial banker and many long time ago, and we talked about the three C's of credit. Had collateral, you had capacity which was cash flow, but the most important one was character. And there's no box now for character, it's gone. Now, what we're describing is a little bit at the outset, there's a number of social forces at work here in Dodd-Frank unfortunately, if you're a fan of bigness, you've got to love Dodd-Frank, because it's entrenched the big banks while at the same time crushing our communities.

And where am I going with this, where I'm going with this is that back to the point of race and things like that, and the unbanked. Is this an issue of say race in the inner city? Or is it a question of just lack of being in a rural community? It seems to me like that's a colorblind issue. And I think I really ask it a very complicated five-point question, but I'm sure you guys are smart and you can figure it out. By the way, you're watching the Bill Walton Show and I'm giving Todd and Brian a chance to answer my very complicated question. Access to credit, urban communities, rural communities, is it different, the same, different-

Brian Johnson (29:34):

It's an incredibly important question. And access to the mainstream financial system is essential for all Americans of all races of all income levels. And to the extent that there are issues for an identified group, they should be addressed. But one of the consequences we've been discussing of kind of homogenized lending where everything looks the same is that, if you, as an applicant don't check all those boxes from government mandated credit risk perspective, you're left on the outside.

And so you have other options, the government is now looking at those other options as well. But promoting financial inclusion is very much a part of the CFPB mission. What this gets to Bill, is there's still not a political consensus over what is the proper approach to consumer protection, or what does it mean? It sounds like a great term, but if what you're really deciding is not just that you're enforcing anti-discrimination laws in the country, so that everybody has an equal opportunity to participate in the financial system, but instead you're moving beyond that to designing products in Washington, DC, and deciding what features can exist, and what can't exist.

By definition you're finding folks that just don't meet the model designed by Washington DC. And there's no ability for institutions to work with an individual to modify an application, or work with them to get them what they need in the way they need it. And that's a fundamental tension there, and it is excluding people from the financial system. And it's a real problem because that is a ladder up towards wealth, and financial safety, and wellness for individuals.

Todd Zywicki (31:26):

Let me give you an example of Brian's point about unintended consequences, and effect on certain groups. An example we talked about Todd-Frank's-

Bill Walton (31:34):

To be clear, I think every major piece of legislation is the law of unintended consequences.

Todd Zywicki (31:38):

Well, that's true. Brian's former boss, Jeff Penciling said that-

Brian Johnson (31:43):

We can discuss why that is too.

Todd Zywicki (31:45):

It's Brian's former boss, Jeff Penciling said about Dodd-Frank, there are at least three unintended consequences on every page of this legislation which remains of his many great quotes. That's one of my favorites, but I'll give you a good example of one that most people haven't heard of and intuitively think it was a good idea. Let's take the Credit Card Act of 2009.

And one of the provisions in the Credit Card Act that was enacted without anything, except without any data to back it up, any support, just some stories, was a provision that limits credit card marketing to college students and says, "You can only get a credit card if you can show you have an independent source of income or a co-signer them, right?" Oh, that's a good idea. There were these college students who have graduated with $3,000 in credit card debt, right?

The fact that they're graduating with 80,000 in student loan debt, apparently wasn't a problem. But let's think about how that actually washes out, think about this, one of the problems in the American system right now is what we call Credit Invisibles, which are people who have no established credit, or they have thin file credit. I mean, it turns out for most Americans which we know from our experience, middle-class Americans, the first place you establish credit is by having a credit card, right?

Those of us who are parents give our kids a credit card and with limited credit line, and we keep an eye on it, and they use it to establish credit and they get on the letter of credit. Let's think about the Credit Card Act of 2009. What happens if you're like our families? Well, what happens? My daughter's not in college yet, but talk to those who are. What happens is, an upper middle-class parent simply co-signs for their child's credit card. And so they get a credit card when they're in college, and they start charging books and stuff like that, and we make sure they pay it off.

What if you're from a low income background, what if you're from a family that doesn't have, or too wealthy parents who can co-sign for your credit card, right? Well, you're stuck. You don't get a credit card if you're a low income person. So now you graduate from college with no credit, right? And so now your first step on the wrong of a credit invisibility. And so you kind of plunge out into the world with no credit, and now you've got to start establishing credit.

And what we find is that that rule that a lot of people thought was a good idea, ends up disadvantaging low-income people. It's no obstacle for higher income people, but lower income people delay their entire life of getting access to a credit card, a student loan, a mortgage, all because of this fact that the regulations don't allow them to prove themselves to be responsible people, even if they are. And it's this misguided paternalism that ends up hurting low-income people.

Bill Walton (34:33):

The laws to protect people, end up making them credit invisibles.

Todd Zywicki (34:37):

Exactly, and if you're credit invisible, when you're young, you're more likely to be credited invisible when you're old, you're more likely to have to rely on payment-

Bill Walton (34:44):

Let me tie this together with a couple other things you've mentioned here, loansharking we established at one point was the major way credit invisibles got money. And then now we've talked about how the regulatory environment has forced a lot of activities out of banks and into what they call very sinister word, shadow banking, or Fintech, or whatever term we're gonna use. Am I conflating something here? I mean, loansharking looks like it's become shadow banking, or a shadow banking is something different from that?

Brian Johnson (35:21):

I mean, shadow banking is the term for anything that's not activities that are financial in nature. That aren't [crosstalk 00:35:28].

Bill Walton (35:28):

And it's to be a pejorative. And the regulators came up with a to make it sound like anything that's happening outside their purview is terrible.

Brian Johnson (35:37):

Unregulated.

Bill Walton (35:38):

Is that unfair?

Brian Johnson (35:38):

Yeah, and you talked about the state federal overlay. After the major pieces of federal legislation states over time have created many state versions of many of those major pieces of legislation, and states traditionally have been the primary regulator in the non-bank lending space. With payday loans, et cetera, states have taken a variety of approaches. And so traditional kind of state regulated activities, installment lending, vehicle, title lending, pawn brokerage activities-

Bill Walton (36:12):

Payday lending falls into that?

Brian Johnson (36:13):

Payday lending falls into that. Now you have post Dodd-Frank, a new federal overlay. And the way that traditional interaction has occurred has been upended, because the CFPB can now establish a new federal floor for traditionally state regulated activities. And states in the law are permitted to go further in terms of being more protective. Well, again, if nobody agrees on what appropriate consumer protection is, how can you decide whether a state law goes further in terms of providing additional protections?

The beauty of the ugliness is in the eye of the beholder in terms of what protection goes further. Typically that means if there's greater regulation, or more restrictions on activities, that's considered greater consumer protection. Well, the effect we're talking about is if it's pushing folks out of a mainstream financial institution, if it's making them credit invisible, or for it's making them unbanked or underbanked, is that a consumer protection? It's not for those folks, it is for the folks that you can identify who are able to continue to participate. It's not for those with marginal credit or no credit history.

Bill Walton (37:26):

I've raised the issues of race and social justice to begin this, how is that playing out? You're watching the Bill Walton Show, I'm here with Todd Zywicki and Brian Johnson. And we're talking about consumer financial protection, which I learned more, it doesn't seem to protect many people, and seems to hurt an awful lot of people. But it's a complicated topic.

Brian Johnson (37:51):

Well, what I can speak to is what the CFPB's new leadership has announced in connection with the Biden administration. The CFPB has responsibilities for enforcing federal anti-discrimination statutes. ECOA, the Equal Credit Opportunity Act is the major substantive one. It says you can't discriminate on a prohibited basis in the extension of credit to a borrower. Makes perfect sense.

Bill Walton (38:18):

One the face of it that sounds just fine.

Brian Johnson (38:20):

Absolutely. And it's an important responsibility of the bureau to carry out. And connected with that, one of the two primary priorities announced by new leadership is explicitly to go beyond that, which is enforcement of non-discrimination statutes, and pursue a goal of racial equity. What's not clear is what that means typically equality versus equity means like outcomes versus like opportunities and the absence of discrimination.

Bill Walton (38:51):

Well, if I applied Critical Race Theory as a lender to that process, or not as a lender, but if I were lender in a Critical Race Theory, we're hanging out there judging this, any decision we make with somebody who's black would be racist, whether you do that. We're basically would want to shut down any kind of standards at all. I mean, where do you draw the line as a lender?

Brian Johnson (39:18):

Well, I think where it's going to come into pulling-

Bill Walton (39:22):

And my banking roots are showing.

Brian Johnson (39:24):

I mean, reading into the CFPB priorities, there's a clear intended focus on the credit reporting system writ large. And they're-

Bill Walton (39:32):

Which they want to get rid of the existing one.

Brian Johnson (39:34):

Well, and there were powerful members of Congress who are very interested in that. And one of the proposals as part of the Biden campaign was to replace Experian TransUnion Equifax with a public credit reporting system run by the CFPB. I think it requires enabling legislation to do it, but think about what that means.

Rather than kind of objective furnished data consolidated by those credit bureaus, and then made available to lenders for purposes of making objective credit determinations, you have potentially a new incentive for a government run credit collection, and reporting process, including with government created credit scores potentially that can and would be used for purposes of credit decisions, and credit allocation.

It could be that for the first time ever that there's no politics involved in this, and this would be a completely objective standalone government program, but you could see the potential problem there, which is that, favored interest groups or political considerations would enter into the equation-

Bill Walton (40:51):

Sure, it's axiomatic, that's going to happen.

Brian Johnson (40:51):

And that would be-

Bill Walton (40:55):

And existing credit reporting system works pretty.

Todd Zywicki (40:57):

Yeah, if you liked the IRS, you'll love the new Federal Law, Consumer Financial Law for Credit Bureau, right? If you think you get good customer service from the IRS and that they don't make any errors, then you should be all in favor of mirroring that. People have a lot of gripes with the credit bureau, credit reporting system, and there are errors in the system, and there are questions of incentives.

It's not a perfect system, that's for sure. And it's a very complicated to get those incentives right, but it can be done. But there's a larger point here that you just made Bill, which is we shouldn't lose track the fact that our modern credit reporting system is truly one of the marvels. And I don't use that word lightly, it's one of the marvels of the modern world, which is that the development of consumer...

In the old days, basically what happened if you wanted to get a loan, there was a good side, as you said, character is one of the C's, but if you didn't know somebody, if you didn't know the bank manager, right? Especially in an era where they had interest rate restrictions, basically what happened was bankers made loans to their buddies, to their golf buddies and the like, and if you are on the fringe, you didn't get a loan from a bank, and you had to deal with installment loan, or something like that in an era when interest rates were very low.

The credit reporting system totally changed that, that is the vehicle by which access to financial services were democratized in this country. First, it was very important for women, which is that, one of the problems is, is consumer finance system grew? The history shows that there was a lot of discretion in local lending officers who often discriminated against women.

And they had all these archaic practices. And so got rid of that. And also obviously with respect to minorities, by basically giving objective data on which you could make these judgments, and what they want to do is so regressive, which is that they want to go back to a system where rather than people allowing their credit reports to speak for themselves as to whether they were credit worthy or not. Now they want to put all these politics back into it, whether you're favored or disfavored.

And basically what they've said is the reason they want to change, they want the government to grab a hold of the credit reporting system is, to deal with the furtherance of racial equity and the like, to deal with the fact that there are statistical differences between races in the like with respect to their credit scores in the like. I think that is a terrible idea, a better idea, I suggest is more competition, which is opening the system to alternative data, to new ways of measuring people's credit worthiness, using cash flow and other sorts of things, and give people a chance to prove that they're credit worthy rather than going-

Bill Walton (44:08):

We've got a system which is mostly 99, 98% of colorblind, has brought every other group in who wouldn't have had access to credit because of their attributes. They now have access to it. If they've got a good number. They want to get rid of that and put it all back onto identity politics.

Todd Zywicki (44:28):

Basically. Yeah, there's a different identity politics than how it was in the old days.

Bill Walton (44:32):

Because the introduction, I wasn't exactly sure where I was going, but I had a feeling like this was somehow underlying a lot of this. We're running at a time-

Brian Johnson (44:42):

Let's say its certainly-

Bill Walton (44:43):

I got about five hours more questions. What are you doing for the rest of the afternoon? How much regulation do we actually need? Seems to me like we've piled on, piled on, piled on, piled on. Now the whole thing's become so ossified and complex that what if you just cut the Gordian knot and freed up the market to provide credit.

Brian Johnson (45:07):

Complex is the right word to say. My view on should we have more or less? That's not precisely the right question to ask the question, should it should be, should we have smart regulation or really dumb regulation? And I think too often regulators believe that they're regulating a system that is complicated. For instance, take your watch, has a lot of pieces, small gears, finely tuned. If you put it together, it works the same way every time.

That's not how a market operates, because human beings aren't cogs in a big machine. Human beings can react. It's a complex adaptive system that we're working in, so when you're trying to apply rules that you would use as a watchmaker to a financial system, you always have the unintended consequences that you talk about, because you can't foresee every possible reaction of millions of individual human beings acting in their own self-interest, and adapting in real time.

So you have different outputs every time you have the same input, and it's not predictable. The question is, what's the proper approach to regulation if you recognize that you need to be regulating for a complex system, not a complicated system?

Bill Walton (46:24):

It's related to the problem we have of modeling the economy, or modeling a pandemic it's so utterly complex, you can't really do it.

Brian Johnson (46:31):

Well, you can't predict with certainty outcomes, because millions of people are reacting in real time to stimulus, and they don't all share the same information, they don't all have the same characteristics, intelligence, interests, et cetera. Some of the lessons that I think can be drawn from this, and Todd wrote a review of Richard Epstein's book, Simple Rules for a Complex World is, should you have a top-down prescriptive approach to regulation? That's how you would govern how to build say, the space shuttle.

Is that the way you should govern the financial system? No. It turns out that for folks who study complexity and study systems dynamics, usually the rules that are best for a complex system are simple rules with decentralized decision-making. That means, should every decision be made by Washington, or should the majority of decisions be left to state regulators, or to local regulators to make those decisions?

And should the rules be highly prescriptive? In other words, in order to originate a mortgage right now in accordance with the CFPB scheme rules, it has to have certain features, can't have other features, you can do this, you can't do et cetera. Or should you have more of a less prescriptive approach instead of prescriptive requirements standards in place? Which is, here's the goal to shoot for, and the government is going to establish those goals. Go figure out the best way to achieve that goal.

Todd Zywicki (48:06):

And I think that one thing that Brian and I both feel very strongly about is this language about deregulation, is in a useful way to think about this, that buys into sort of the progressive mindset that there's a continuum between more and less, the more regulation is good for consumers and less regulation is good for industry. That's not useful, the way we should be thinking about regulation is, how do we make markets work better?

How do we pass regulations that are good for consumers, industry, and the economy at large, that allows consumers to find the products and services that they need to make their lives better? Because that's what this is really about, and there's basically three principles, I think that matter here, and we talk about our task force report. The first is we have to have a system that's more flexible and more modern.

The system right now was built for a 1970s economy. In 1970s, analog paper-based economy, computers hardly existed at that point. Nowadays things change so quickly, there's constant innovation, there's constant changes, there's constant... Everything's away. And just look at the past year, look at the pandemic. What we've seen during the pandemic, for example, on electronic payments, for example, is what was going to take 15 years, took nine months, right?

And our system is just not set up to deal with those sorts of changes. We've had three major crises that have impacted consumers in the last 20 years, right? Y2K, 2008 financial crisis and the pandemic, and nobody thinks those are going to be the end. We've got to have a more flexible system that's more modern, more adaptable to changes. There were laws in states, for example, that still required in-person real estate closings. In-person real estate appraisals, just total special interests laws that did nothing for consumers, but we had a problem with.

The second thing is information, consumers get information differently now. Delivering information just in time to people's cell phones, allowing them to read disclosures on their cell phones. That's important for people to be able to get what they need, and think about what consumers actually need to know, rather than the dozens and dozens of disclosures that people have to wait through without knowing what's important to me. We need to have a better system that focuses on that.

The third thing is the way forward and the way it's always been as competition and innovation, whether it was the credit card issuers, who took advantage of the changes in the regulatory framework in '70s, to create access to credit cards for everybody. Nowadays, Walmart should begin a banking charter if Walmart, wants a banking charter. And to Deonna McWilliams during the Trump administration, she allowed industrial loan companies like Square and others to get access to banking charters, we need more of that.

Fintech should be allowed, and we need a national Fintech charter that can lend to consumers anywhere in the country. We need to explore allowing non-banks access to the payment system. Whether it's Amazon or whoever to set up their own financial services, instead, what are we getting? We're getting a national government, a credit bureau. The answer they say is the post office. That while the rest of us get FedEx banking, poor people can have can go to the post office, right?

Nine to five post office banking, they think is the cure for financial inclusion. It's crazy, the idea... That's a 19th century regulated public utility model of financial inclusion that solves a problem that isn't a problem, which is access, right? That's not why consumers are unbanked. We need more choice, more competition, more innovation. That's how we're going to solve financial inclusion in this country.

Bill Walton (52:00):

Todd, thank you. That was excellent. Brian, excellent. I feel like we've just touched the tip of the iceberg, and I was confused about this before we came into it, and I think you guys have clarified it somewhat, but I think we can take it further. Let's figure out when we can get you back to get into some of these solutions you talked about, and I'm particularly interested in free market solution, because where we're going now is the wrong direction. Where can we find your writings, Todd?

Todd Zywicki (52:29):

You can find that either at the Cato Institute or on my website at Antonin Scalia Law School.

Bill Walton (52:35):

And Brian, what about you? Are you in Alston & Bird? You guys-

Brian Johnson (52:38):

Writing these days on the Consumer Finance Abstract blog for our firm. And also contributing-

Bill Walton (52:43):

What's the URL?

Brian Johnson (52:46):

Consumerfinanceabstract.com. And also contributing to the Heritage Foundation.

Bill Walton (52:52):

Great guys. Well, thanks for edifying me, and I hope we had a fight. All of you, who've been listening, and watching, and we'll be talking with you next time again soon. So thanks for joining. I hope you enjoyed the conversation, want more? Click the subscribe button, or head over to the billwaltonshow.com to choose from over 100 episodes.

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