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THE LAW AND ECONOMICS OF CONSUMER DEBT COLLECTION AND ITS REGULATION

Todd J. Zywicki

I. INTRODUCTION

The ability to effectively and efficiently collect consumer debts is a crucial underpinning of the American economy. Without the ability to enforce contracts, consumer lending would be scarce and expensive. Everyone would be worse off.

Yet collecting debt from insolvent or reluctant consumers is a complicated enterprise, inherently fraught with a conflict of interest between creditors and debtors. Consumers may dodge or mislead creditors, and creditors will try to track down delinquent consumers to get them to pay. If consumers are routinely subject to collection methods that they perceive as unfair, they will be reluctant to borrow.

The regulation of debt collection activities presents a challenge from an economic perspective. In theory, well-designed debt collection rules can aid both borrowers and lenders by increasing access to and reducing prices for consumer credit. But poorly designed rules can reduce the effectiveness of debt collection, which will in-

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crease losses and lead to higher prices and less access to credit for consumers, especially low-income and high-risk consumers. Rules intended to protect consumers from some credit collection practices could lead creditors to use alternatives that consumers prefer even less.

The economics and regulation of debt collection took on heightened scrutiny after the Consumer Financial Protection Bureau (CFPB) announced a rulemaking procedure (Advance Notice of Proposed Rulemaking, or ANPR) to consider amendments to the federal regime governing debt collection practices.¹ This article provides an economic framework to guide the CFPB in its efforts to issue new regulation of the debt collection industry based on sound economic and empirical analysis.

Effective regulation of creditor remedies requires 1) an understanding of the role that effective debt collection plays in the consumer credit system, 2) proper identification of the purported market failure to be corrected, and 3) a determination of whether proposed regulations will, in fact, ameliorate those market failures such that the benefits of the regulations to consumers will exceed the costs. Moreover, as the CFPB considers new regulations, it is not writing on a clean slate. Before imposing new regulations, the CFPB should first examine the effectiveness of old regulations and the marginal effect of adding new rules to old.

Although controversial at the time of adoption, earlier generations of legislation and regulation of debt collection practices have generally been accepted as beneficial to consumers and the economy because they eliminated archaic and oppressive practices. In a sense, the low-hanging fruit of regulation has been picked - those practices that continue in use are much more likely to have overall economic benefits that exceed their costs, at least in many contexts. As a result, further regulation requires nuance to preserve the efficacy of collections.

¹ Debt Collection (Regulation F), 78 Fed. Reg. 67848 (proposed Nov. 12, 2013) (to be codified at 12 C.F.R. pt. 1006).

Moreover, most major debt collection legislation and regulations were issued in the 1970s and 1980s, before electronic communications and cell phones fundamentally transformed consumers' communication habits. In light of this history and recent developments, the CFPB must consider all the marginal benefits and costs of any new regulation of debt collection practices as well as alternatives to regulation, such as industry self-regulation, that can provide flexibility to the regulatory system.

This paper examines the law and economics of debt collection and its regulation. After providing a background on the industry and the historical evolution of its regulatory structure, the paper focuses on the basic economics of debt collection and the regulatory regime that governs it. The last section of the paper applies the discussion developed herein to consider some of the major elements of the CFPB's proposal to regulate debt collection.

II. BACKGROUND: THE DEBT COLLECTION INDUSTRY

Most consumer debts, whether credit card debt, student loans, medical debt, auto loans, or mortgages, are paid in their ordinary course. According to one estimate, approximately 95% of all consumer debt is paid on time, and less than half of consumers have been reported as thirty or more days late on a payment.² Even this high level of voluntary payment depends in part on the perceived effectiveness of the debt collection system in the event of nonpayment.

Yet many consumers do not pay their debts in a timely and voluntary manner. The CFPB estimates that some thirty million American adults had debts in the collection process in 2013.³ Approximately two in ten con-

² See DBA INT'L, *THE DEBT BUYING INDUSTRY: A WHITE PAPER* 4 (Jan. 8, 2015),

http://www.dbainternational.org/members_only/DBA_WhitePaper.pdf [hereinafter DBA INT'L, *DEBT BUYING*] (citing Fair Isaac Corp.).

³ See 2014 CFPB FAIR DEBT COLLECTION PRACTICES ACT: CFPB ANN. REP., at 7 (Mar. 20, 2014), http://files.consumerfinance.gov/f/201403_cfpb_fair-debt-

sumers have been more than ninety days overdue on an account at some time.⁴ Although many delinquent debts are collected by the creditors that issued the credit, many debts are transferred to debt collectors, who try to collect the debt on a contingency basis, or are sold outright to debt buyers, who collect in their own name. In addition, many debts are collected through legal proceedings in court; legal practices involved in collection have grown steadily over time.⁵

The industry is subdivided still further because some collection firms and debt buyers specialize in the types of debt that they collect. For example, firms may specialize in the collection of credit card, student loan, medical, or other debt.⁶ In some instances, specialization occurs because certain types of debt are subject to certain regulatory limits that tend to promote specialization. Examples include medical debts, which are subject to particular privacy requirements, as well as student loan debts, for which collectors have broader collection powers under the law.⁷ Specialization may also result from variance in the size of outstanding debts among different types of debt. For example, the average face value of outstanding balances on mortgages and auto loans purchased by debt buyers tends to be substantial (\$48,669 for mortgages and \$6,489 for auto loans), whereas the average size of the outstanding balance on utilities, telecommunications, and bad checks is relatively small (under \$500).⁸ The methods used to collect debts with an average size of a few hundred dollars will differ from those used to collect debts with an average size of several thousand dollars.

In addition, within each subsector of the industry there is substantial competition. For example, third-party

collection-practices-act.pdf [hereinafter CFPB, FDCA ANN. REP.].

⁴ DBA INT'L, DEBT BUYING, *supra* note 2, at 4.

⁵ See Debt Collection (Regulation F), *supra* note 1, at 67850.

⁶ See *id.*

⁷ See *id.*

⁸ U.S. FED. TRADE COMM'N, THE STRUCTURE AND PRACTICES OF THE DEBT BUYING INDUSTRY T-4, table 4 (Jan. 2013), <http://www.ftc.gov/os/2013/01/debtbuyingreport.pdf> [hereinafter FTC, STRUCTURE AND PRACTICES].

collection agencies have been getting larger, and the industry is becoming more consolidated, but the third-party debt collection industry still has many small participants. With respect to the debt-buying industry, for example, the Federal Trade Commission (FTC) reports that in 2008 the nine largest debt-buying firms purchased 76.1% of all debt sold in the United States that year.⁹ However, the respective market shares of industry leaders vary greatly over time, suggesting that competition within these industries is robust.¹⁰ The FTC reports that debt buyers purchased an estimated \$72.3 billion in consumer debt in 2008.¹¹ About 75% of all debt sold each year to debt buyers is credit card debt.¹² According to the FTC, on average, debt buyers paid four cents for each dollar of debt purchased; however, the figure varies according to the age of debt (debt buyers pay more for newer debt) and type of debt (for example, paying more for mortgage and credit card debt than for utility and telecommunications debt).¹³ With respect to debt collectors, according to one estimate, more than 4,000 third-party debt collection firms employed more than 140,000 people and reported revenue of \$11.7 billion in 2010.¹⁴ According to a study that Ernst & Young conducted for ACA International, a national trade association representing third-party contingency collection agencies, the collection industry returned \$44.6 billion to creditors in 2010¹⁵ and \$44.9 billion in 2013.¹⁶

⁹ FTC, STRUCTURE AND PRACTICES, *supra* note 8, at 14.

¹⁰ *Id.* at 14-15.

¹¹ *Id.* at 7 (citing *Credit Card Debt Sales in 2008*, 921 NILSON REP. 10 (Mar. 2009)).

¹² FTC, STRUCTURE AND PRACTICES, *supra* note 8, at 13.

¹³ *Id.* at 23-24, Table 7 at T-8.

¹⁴ ROBERT M. HUNT, UNDERSTANDING THE MODEL: THE LIFE CYCLE OF A DEBT 10 (June 6, 2013), https://www.ftc.gov/sites/default/files/documents/public_events/ife-debt-data-integrity-debt-collection/understandingthemodel.pdf (presentation at the FTC-CFPB Roundtable).

¹⁵ ERNST & YOUNG, THE IMPACT OF THIRD-PARTY DEBT COLLECTION ON THE NATIONAL AND STATE ECONOMIES 6 (Feb. 2012).

¹⁶ ERNST & YOUNG, THE IMPACT OF THIRD-PARTY DEBT COLLECTION ON THE NATIONAL AND STATE ECONOMIES IN 2013 (July 2014) (report prepared for ACA International).

Barriers to entry in the debt collection industry have historically been very low and competition has been robust. Third-party debt collectors and buyers have tended to operate on a local basis.¹⁷ The industry appears to concentrate over time as a result of government regulation, especially regulatory guidance issued by the Office of the Comptroller of the Currency (OCC) and Dodd-Frank financial reforms.¹⁸ The elimination of smaller debt collecting and debt buying businesses, however, has adverse consequences for consumers. Smaller businesses, for example, may have a better understanding of local economic conditions in terms of developing workable repayment plans for consumers.¹⁹ Smaller businesses may also be able to exert supervisory authority by management over the activities of those in contact with consumers, thereby providing greater safeguards against overreaching behavior.

Costly regulations that eliminate small collections firms may also harm consumers by dampening competition. Often times, consumers have multiple accounts in collections with different collection agencies. Consumers, with their limited resources, may benefit from competition among debt collectors by playing them against each other by choosing which debts to pay. Thus, competition can empower them with leverage when negotiating a settlement or payment plan and by rewarding the debt collector that is the most professional in terms of respecting a consumer's rights and dignity.

III. REGULATORY BACKGROUND

Debt collection practices are subject to extensive

¹⁷ See U.S. FED. TRADE COMM'N, COLLECTING CONSUMER DEBTS: THE CHALLENGES OF CHANGE—A WORKSHOP REPORT 15 (Feb. 2009), <http://www.ftc.gov/bcp/workshops/debtcollection/dcwr.pdf> [hereinafter FTC, COLLECTING CONSUMER DEBTS].

¹⁸ See Tanya D. Marsh, *The Unknown Costs of Dodd-Frank*, DBA: MAGAZINE, Fall 2014, at 16.

¹⁹ See Brian Fair, *Keep Small Business in the Credit Cycle*, HILL (May 20, 2016, 6:00 PM), <http://thehill.com/blogs/congress-blog/economy-budget/242594-keep-small-business-in-the-credit-cycle>.

regulation at both the state and federal levels. Determining whether new regulations will benefit consumers requires an assessment of their marginal costs and benefits. In turn, this determination requires an understanding of the existing regulatory framework and the way new regulations fit within that framework. In particular, as will be seen, many of the most questionable debt collection practices have already been prohibited or heavily regulated. Further regulation presents much closer judgments as to whether the marginal benefits of additional regulation will exceed the marginal costs for consumers.

Collection activities fall into two basic categories: legal and extralegal.²⁰ Legal actions refer to bringing a lawsuit to collect a debt or, where applicable, bringing a legal action to seize a debtor's property, such as foreclosing on a home. Extralegal actions refer to the variety of informal actions that a creditor can initiate to persuade a debtor to pay some or all of a debt without recourse to legal process. Examples of such actions include sending letters, making phone calls, or taking other similar actions that fall short of initiating a lawsuit. In general, extralegal processes tend to be less expensive for creditors, debtors, and society at large.

Regulation of debt collection also can take two forms. In some instances, regulation is prescriptive, such as an outright prohibition on the enforceability of certain contract terms or on the use of certain remedies. For example, the remedy of imprisonment for debt was prohibited throughout the United States in the 19th century.²¹ Other less extreme practices, such as contacting a debtor's employer about a delinquent debt, were outlawed more recently, especially during a wave of regulatory activity beginning in the 1970s. Other regulations are not prescriptive but seek to distinguish between legitimate contacts with a debtor and harassing or intimidating be-

²⁰ Extralegal collection practices, such as phone calls and letters, should be distinguished from illegal methods, such as loan sharking, which rely on the threat and use of physical harm.

²¹ *Debtors' Prison*, WIKIPEDIA, https://en.wikipedia.org/wiki/Debtors%27_prison#United_States_of_America.

havior, such as rules governing the times at which a debtor may be contacted by phone or the permissible content of communications.

Creditors' remedies historically were governed by state law, consistent with the reality that most consumer credit transactions were between consumers and in-state lenders, such as local banks, personal finance companies, and local retailers such as department stores or appliance stores.²² Several states placed new limits on creditors' remedies when they adopted the Uniform Consumer Credit Code or similar consumer credit protection laws beginning in the late 1960s.²³ Today, even though the federal government has increased its role, creditors' remedies and collection practices remain heavily regulated at the state level as well.

From the beginning, the federal government also has exercised some role in the regulation of creditors' remedies. Indeed, a major purpose of the U.S. Constitution was to restrain debtor-friendly state legislatures from enacting laws that frustrated creditor collection efforts, especially by out-of-state creditors. The Full Faith and Credit Clause, diversity jurisdiction for federal courts, Bankruptcy Clause, and the Contracts Clause were all in large part designed to tie the hands of debtor-friendly state legislatures and to aid in the collection of debt.²⁴

One of the first significant federal interventions into the debt collection sphere came in 1968 "when the Federal Trade Commission (FTC) published guidelines describing explicit collection practices it deemed to be unfair or deceptive trade practices and therefore subject

²² See THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN & TODD ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY 520 (2014).

²³ See Peter V. Letsou, *The Political Economy of Consumer Credit Regulation*, 44 EMORY L.J. 587, 590 (1995).

²⁴ See, e.g., Todd J. Zywicki, *Bankruptcy Clause*, HERITAGE GUIDE CONST., <http://www.heritage.org/constitution#!/articles/1/essays/41/bankruptcy-clause> (noting that the original purpose of the Bankruptcy Clause was to strengthen interstate collection of debts, not to protect debtors).

to prosecution.”²⁵ According to economist Robert Hunt, “[i]n the 20 years ending in 1977, the FTC filed cases against approximately 10 collection agencies a year.”²⁶

The first federal statutory regulation of ordinary creditors’ remedies came in 1970 with the Consumer Credit Protection Act, which restricted the use of wage garnishment to a maximum of 25% of wages, with certain exceptions, such as for the Internal Revenue Service.²⁷ Today, some states augment the federal limits by restricting wage garnishment further or prohibiting it altogether.²⁸ Also in 1970, Congress enacted the Fair Credit Reporting Act.

In 1977, Congress passed the Fair Debt Collection Practices Act (FDCPA). The Act was motivated by several concerns. First, Congress considered regulation to be insufficient in some states. According to a U.S. Senate report at the time, thirteen states had no debt collection laws at all, and Congress considered the laws in sixteen more states to be inadequate.²⁹

Second, even where state regulation was thought in principle to be adequate, Congress believed that several factors had evolved to make state regulation less effective than in the past. In large part, the increased federal role reflected the growing interstate nature of consumer credit markets, especially the development of credit card lending, and the perceived difficulty of state-based regulation of out-of-state creditors and debt collectors. Less obvious but no less important, the dramatic advancements in telecommunications technology—particularly the rapid drop in the cost of long-distance phone calls—

²⁵ Robert M. Hunt, *Collecting Consumer Debt in America*, PHILA. FED. BUS. REV. Q2, at 17 (2007).

²⁶ *Id.*

²⁷ See Richard M. Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168, 178-79 (2002).

²⁸ See Chuck Rice, *A Guide Through the Garnishment Jungle*, KILPATRICKTOWNSEND.COM, available at http://www.kilpatricktownsend.com/en/Knowledge_Center/Publications/Articles/2000/04/AGuideThroughtheGarnishmentJungle.aspx (last visited May 6, 2016).

²⁹ See Hunt, *supra* note 25, at 20; see also S. REP. NO. 95-382, at 1697 (1977).

increasingly made interstate efforts to collect debts less expensive. Not only did those developments increase the likelihood that a debtor might borrow from an out-of-state creditor, but also if the debtor borrowed from an in-state lender, the debt still might at some point be assigned or sold to an out-of-state third-party debt collector.³⁰ Moreover, growing interstate labor mobility could have the opposite consequence if the debtor changed his or her place of residence and turned a former in-state debtor-creditor relationship into an interstate one.

The FDCPA was designed to prohibit collection practices deemed to be unfair or harassing to consumers—such as contacting third parties—and to regulate the type of information that can be disclosed to third parties. The Act also limited the times and places that a debtor could be contacted, and it prohibited communications that are obscene or threatening, that are false or deceptive in content, or that harass the consumer, such as repeated telephone calls. The FDCPA further required the collector to provide certain information to the debtor and established protections and procedures for consumers to dispute a debt. The Act permitted injured consumers to collect damages for violations of the law, and it authorized class action suits against debt collectors. Moreover, although the federal protections are extensive, they are not preemptive: states are permitted to enact stronger consumer protections that go beyond those in the FDCPA. Many do so. Writing almost a decade ago, Robert Hunt noted that at the time more than forty states had their own laws that applied to third-party debt collectors and that more than thirty states had laws that applied to creditors collecting their own debts.³¹

One of the most notable elements of the FDCPA is its limited coverage. By its terms, it applies only to third-party debt collectors and not to originating creditors. Hunt characterizes the rationales for heightening regulation of third-party debt collectors but not the originating creditors as “somewhat convoluted,” but he identifies

³⁰ See Hunt, *supra* note 25, at 20.

³¹ See *id.*

several possible reasons for the distinction.³² First, many lenders, especially financial institutions, were subject to ongoing supervision by banking regulators; thus, their improper practices were thought to be easier to detect and punish than were those of debt collectors. Second, barriers to entry in the industry were low, so it was feared that if a firm was disciplined, its employees could easily form again under a different name or in a different state with minimal effort. Thus, deterrence was thought to be weaker for third-party collectors than for originating creditors.³³

Third, and most relevant for contemporary debates, it was argued that debt collectors would be less constrained by concern about goodwill and other reputational issues than would be creditors collecting their own debts because creditors would be collecting from their own customers and thus be unwilling to damage those relationships.³⁴ Consistent with the hypothesis that third-party debt collectors would be willing to use more intensive debt collection techniques than originating creditors would, it was also reported at the time that consumers complained more frequently against third-party debt collectors than against creditors.

In addition, there was the simple matter of practical politics. Given the controversial nature of the legislation at the time, Hunt claims that the law would not have passed had original creditors been included. He characterizes the legislation as having been “highly controver-

³² *Id.* Hunt notes that at the time of the FDCPA, although debt collectors increasingly crossed state lines, most debtors still borrowed from banks and retailers within their state. Thus, it was argued that state regulation would be adequate to regulate original creditors and that federal regulation was unnecessary. In light of the growth of interstate consumer credit markets since that time, that distinction no longer applies. Thus, the text focuses on the arguments that are still possibly relevant.

³³ *Id.* The industry remains highly fragmented and competitive today. See FTC, STRUCTURE AND PRACTICES, *supra* note 8, at 15-16.

³⁴ See Hunt, *supra* note 25, at 20; see also Debt Collection (Regulation F), *supra* note 1, at 67853 (“Congress excluded such creditors in 1977 because it concluded that the risk of reputational harm would be sufficient to deter creditors from engaging in harmful debt collection practices.”).

sial," noting that it was criticized as infringing on traditional state power, as being overly restrictive, and as being "an attempt to protect deadbeats that would reduce the efficiency of the credit market."³⁵ In fact, the FDCPA passed the House of Representatives by only one vote in 1977.³⁶

Since that time, the federal government has remained active in the regulation of debt collection. In 1985, the FTC issued its credit practices rule, which, among other provisions, made unenforceable several remedies that had previously been permitted under law.³⁷ Prohibited remedies included confessions of judgment, wage assignment, waivers of statutory property exemptions, and nonpurchase money security interests in household goods. Although these remedies were technically legal in some states, they were rarely preserved in consumer credit contracts and, even if preserved in the contract, were even less frequently invoked in practice.³⁸ The Federal Reserve Board,³⁹ the Federal Home Loan Bank Board,⁴⁰ and the National Credit Union Administration⁴¹ adopted similar rules as well. Until the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which created the CFPB, the FTC was the primary federal enforcer of federal debt collection regulations.

Dodd-Frank established the CFPB and in 2010 transferred primary responsibility for enforcing federal laws governing debt collection from the FTC to the CFPB. In addition, Dodd-Frank provided general authority to the CFPB to engage in supervision, enforcement, and

³⁵ Hunt, *supra* note 25, at 20.

³⁶ *Id.*

³⁷ Trade Regulation Rule: Credit Practices, 49 Fed. Reg. 7740 (Mar. 1, 1984).

³⁸ See DURKIN ET AL., *supra* note 22, at 525-29 (describing empirical evidence on contracting and use of various remedies prior to federal regulation).

³⁹ Unfair or Deceptive Acts or Practices: Credit Practices, 50 Fed. Reg. 16695 (Apr. 29, 1985).

⁴⁰ Consumer Protections: Unfair or Deceptive Credit Practices, 50 Fed. Reg. 19325 (May 8, 1985).

⁴¹ Federal Credit Union; Prohibited Lending Practices, 52 Fed. Reg. 35060 (Sept. 17, 1987).

rulemaking and to issue guidance to prevent “unfair, deceptive, and abusive acts or practices” by covered parties, including debt collectors. Pursuant to this authority, the CFPB brought its first enforcement action in October 2012.⁴² That same month, the CFPB issued its larger participant rule providing for supervision of large debt collection agencies, which it estimated would cover approximately 175 debt collectors that account for over 60% of the industry’s annual receipts.⁴³ In July 2013, the CFPB issued two supervisory bulletins intended to offer guidance to the industry. One provided guidance on the CFPB’s understanding of unfair, deceptive, and abusive acts and practices when collecting debts,⁴⁴ and the other pertained to representations about credit reports and credit scores made during debt collection efforts.⁴⁵ At the same time, the CFPB also began accepting consumer complaints regarding debt collectors.⁴⁶

Under the watch of both the FTC and the CFPB, debt collection has regularly been the subject of the largest number of consumer complaints, with complaints against third-party debt collectors constituting a majority of those grievances. For example, the CFPB reports that from July 2013 until the end of that year, it received approximately 30,300 complaints from consumers about debt collection efforts—most commonly about debts that the consumer claimed were not owed or about what the debtor claimed were improper “communication tactics,”

⁴² See Debt Collection (Regulation F), *supra* note 1, at 67851.

⁴³ Defining Larger Participants of the Consumer Debt Collection Market, 77 Fed. Reg. 65775 (Oct. 31, 2012) (to be codified at 12 C.F.R. pt. 1090).

⁴⁴ CFPB, CFPB BULL. 2013-07, PROHIBITION OF UNFAIR, DECEPTIVE, OR ABUSIVE ACTS OR PRACTICES IN THE COLLECTION OF CONSUMER DEBTS (July 10, 2013), http://files.consumerfinance.gov/f/201307_cfpb_bulletin_unfair-deceptive-abusive-practices.pdf.

⁴⁵ CFPB, CFPB BULL. 2013-08, REPRESENTATIONS REGARDING EFFECT OF DEBT PAYMENTS ON CREDIT REPORTS AND SCORES (July 10, 2013), http://files.consumerfinance.gov/f/201307_cfpb_bulletin_collections-consumer-credit.pdf.

⁴⁶ See *Submit a Complaint*, CFPB, <http://www.consumerfinance.gov/complaint/#debt-collection> (last visited Mar. 21, 2016).

such as repeated telephone calls.⁴⁷ Yet given that some thirty million debts are in the collection process in any given year, a relatively small number of consumers register formal complaints.⁴⁸

With respect to the accuracy of debts, the FTC estimates that 3.2% of the debts that debt buyers attempt to collect are disputed.⁴⁹ According to a regulatory comment filed by the Debt Buyers Association International (DBA International), the experience of DBA International's members suggests that 85% of debt buyers claim that less than 5% of their accounts are disputed.⁵⁰ In addition, the FTC finds that over half of debts disputed by consumers are subsequently verified; thus, on average, about 1-2% of consumer debt that debt buyers seek to collect are actually disputed and found to be invalid for some reason.⁵¹ Moreover, the verification rate varies by age and type of debt. For example, newer debt is verified more frequently than older debt, and credit card debt is verified more frequently than medical, telecommunications, or utility debt.⁵² According to the DBA International survey, 82% of debt buyers report that they find an error less than 5% of the time that a debt is disputed, and only 1.2% state that they find an error more than half the

⁴⁷ CFPB, FDCPA ANN. REP., *supra* note 3. For 2013, the FTC received 73,211 complaints from consumers about debt collectors, mostly about third-party debt collectors. *Id.* at 17. According to a review by the Government Accountability Office of collections on credit card debt, first-party collection efforts generate fewer consumer complaints than do third-party collectors, and complaints against originating creditors are disproportionately against subprime credit card issuers. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO 09-748, CREDIT CARDS: FAIR DEBT COLLECTION PRACTICES ACT COULD BETTER REFLECT THE EVOLVING DEBT COLLECTION MARKETPLACE AND USE OF TECHNOLOGY 30-34 (Sept. 2009).

⁴⁸ DBA INT'L, DEBT BUYING *supra* note 2, at 4. Of course, surely some dissatisfied consumers do not register a formal complaint; thus, this figure is not exhaustive.

⁴⁹ FTC, STRUCTURE AND PRACTICES, *supra* note 8, at 38.

⁵⁰ DBA INT'L, INTRODUCTION TO DBA'S ANPR RESPONSE 30 (Feb. 28, 2014) [hereinafter DBA INT'L, INTRODUCTION].

⁵¹ FTC, STRUCTURE AND PRACTICES, *supra* note 8, at 40-41.

⁵² *Id.*

time.⁵³

At the same time that the CFPB was assuming responsibility for administering federal laws regarding debt collection, the OCC was considering new risk management guidance to establish best practices regarding the use of debt collectors by nationally chartered banks.⁵⁴ On August 4, 2014, the OCC issued its guidance with respect to the use of debt buyers, cautioning banks about potential risks associated with using third-party debt collectors.⁵⁵

In November 2013, the CFPB issued an Advance Notice of Proposed Rulemaking (ANPR) seeking information and stating the possible need for further regulation of the debt collection system.⁵⁶ In its ANPR, the CFPB proposes several dramatic changes to the debt collection system. First, it proposes extending the provisions of the FDCPA, which currently apply only to third-party debt collectors, to creditors collecting their own debts.⁵⁷ The rationale for this proposal is that “experience since passage of the FDCPA suggests that first-party collections are in fact a significant concern in their own right.”⁵⁸ Second, the CFPB proposes new requirements for the type of information that must be transferred from creditors to third-party collectors to improve the accuracy and efficiency of the debt collection system and to facilitate the

⁵³ DBA INT’L, INTRODUCTION, *supra* note 50, at 30.

⁵⁴ See *Shining a Light on the Consumer Debt Industry: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the S. Comm. on Banking, Housing, and Urban Affairs*, 113th Cong. (July 17, 2013).

⁵⁵ OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. 2014-37, CONSUMER DEBT SALES: DESCRIPTION: RISK MANAGEMENT GUIDANCE (Aug. 4, 2014), <http://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-37.html> [hereinafter OCC BULL]

⁵⁶ Debt Collection (Regulation F), *supra* note 1.

⁵⁷ *Id.* at 67853.

⁵⁸ *Id.* The CFPB argues that this concern about originating creditors is longstanding, noting the FTC’s assertion made two years after the FDCPA that “there is little difference between the practices employed by certain creditors and those employed by debt collection firms. Indeed, there is evidence that the collection practices of creditors may be more egregious than those practices engaged in by debt collection firms.” *Id.* (quoting 1979 FTC, FDCPA ANN. REP. 7).

provision of information to consumers.⁵⁹ Third, the proposed rulemaking would impose new requirements regarding the notice to be provided to consumers when a debt is placed with a third-party collection agency and amendments to the processes by which consumers can contest debts and restrict collection processes. Fourth, the rulemaking would impose new regulations on the methods and content of permissible communications with debtors in light of changes in communications technology since the FDCPA was enacted. Fifth, the CFPB would clarify what constitutes unfair, deceptive, or abusive debt collection practices. Sixth, the CFPB is considering new rules regarding communications by creditors and the collection of debts that are outside of the applicable statute of limitations. Seventh, the CFPB is considering reforms to the debt collection litigation process, particularly focusing on the perceived problems of inconvenient venue for debtors and the propensity of debt collection litigation to result in default judgments. Finally, the CFPB is proposing certain regulatory and record-keeping requirements designed to smooth the coherence of federal law with state law and regulation and to better regulate and supervise debt collectors on an ongoing basis.

In short, after decades of legislation, regulation, enforcement, and analysis, the debt collection industry, especially with respect to third-party entities such as collectors and debt buyers, is heavily regulated at both the national and the state levels. The CFPB should take into account the extensive existing regulations as it assesses whether the marginal benefits of further regulation will exceed the marginal cost for consumers.

IV. UNDERSTANDING THE ECONOMICS OF DEBT COLLECTION AND ITS REGULATION

As the CFPB deliberates on whether to add new debt collection regulations or to modify existing regulations, it should begin by considering the role of debt collection in the operation of the overall consumer credit

⁵⁹ Debt Collection (Regulation F), *supra* note 1, at 67854-56.

system. Only after understanding how consumer credit contracts and debt collection function should the CFPB consider the potential for regulation to improve the operation of the system.

A. *The Economics of Consumer Credit Contracts and Collection Practices*

For a lender to make a loan profitably, it must be able to price the risk of loss accurately.⁶⁰ Therefore, if the risk of loss is higher, a lender will need to charge a higher price to compensate for the heightened risk of loss. If the lender is unable to accurately price the risk of the loan, such as because of regulatory limits, then the lender will reduce its risk exposure either by lending to fewer borrowers, in particular, by limiting credit offered to higher-risk borrowers, or by lending less to the same borrowers by reducing credit lines and loan size.

One element of the risk of loss is the ability to collect from a debtor who defaults. If collection powers are weaker, the loss rate will be higher, for two reasons. First, if the creditor is more limited in its ability to collect, it will recover less from the defaulted debtor and collection efforts will be costlier. Second, if the consequences of default are less severe, borrowers will be more likely to default. As a result, greater restraints on the ability of creditors to collect will tend to increase their losses. In turn, lenders will respond to this increased risk of loss by raising prices to compensate or by reducing risk exposure.

As an *a priori* matter, therefore, it is not clear whether consumers as a whole will be made better or worse off by stricter regulation of collections. Although consumers who are already in default generally will benefit from greater restraints on collections, the benefit will come at the expense of other consumers who may end

⁶⁰ See *The Condition of Small Business and Commercial Real Estate Lending in Local Markets: Hearing Before the H. Comm. on Fin. Serv. and Comm. on Small Bus.*, 111th Cong. 3 (Feb. 26, 2010) (testimony of Todd J. Zywicki, George Mason University and Mercatus Center), <http://mercatus.org/publication/condition-small-business-and-commercial-real-estate-lending-local-markets>.

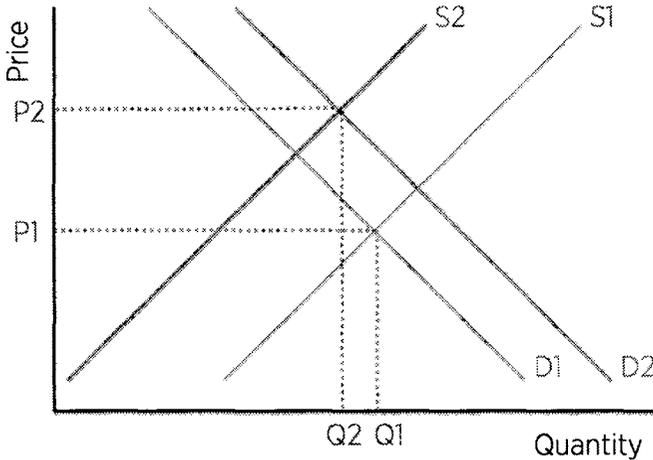
up paying more or obtaining less access to credit, including the borrower currently in default, who may want new credit in the future. Because at the time of making a loan a lender cannot perfectly predict which particular borrowers will eventually default, *all* potential borrowers will be forced to pay higher costs for credit, but especially riskier borrowers.⁶¹ Conversely, weakening creditor remedies will increase the risk of loss for creditors, thereby raising the cost of lending. Such a reform will lead to a reduced supply of lending and higher prices, everything else being equal.⁶²

Strengthening restrictions on creditor remedies, therefore, will simultaneously shift the supply curve inward by increasing the loss rate and thus the cost of lending, and the demand curve outward by increasing consumer demand as a result of smaller adverse consequences from default. As shown in Figure 1, the overall effect of the simultaneous increase in demand and reduction in supply from regulatory or contractual restrictions on debt collection is ambiguous in terms of the overall quantity of credit.

⁶¹ See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981). For example, although credit scores can predict a propensity for default, they are probabilistic among those in a particular credit score range and thus they imperfectly predict default for particular borrowers. Thus, all potential borrowers within that credit score range will pay a similar risk premium.

⁶² At the extreme, the terms of a loan could be made entirely unenforceable on default. In such a world, some lending actively would likely still occur because of the presence of extralegal restraints on default, such as the constraints of repeat dealing, reputation, morality, conscience, collateral, economic hostage taking, or lending between family members. See Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5 (1985). The supply of credit would be much lower in a world without enforceable contracts.

Figure 1: Effect of Restrictions on Debt Collection Remedies



Note: P = price; Q = quantity; D = demand; S = supply.

As shown in Figure 1, placing stricter limits on creditors' remedies will cause supply to shift in from S1 to S2 while also increasing consumer demand from D1 to D2. Overall quantity shifts from Q1 to Q2, illustrated here as a reduction in the equilibrium quantity amount. But, in theory, the increase in demand could exceed the reduction in supply if consumers valued the ability to be free from certain potential remedies more than creditors valued access to those remedies, even though the nominal price of credit, such as interest rates or down payments, were higher.⁶³

⁶³ To put the matter differently, although the nominal price of credit includes obvious price terms, such as the interest rate or down payment, the full price of credit would also include other elements of the loan, such as creditor collection rights on default. Thus, con-

As a result of these offsetting adjustments, it is unclear as an *a priori* matter whether tighter restrictions on creditor collection remedies will increase consumer welfare. Because the total price to consumers includes the contingent costs associated with default, consumers may be willing to pay more on some margins, such as a higher interest rate, to prevent creditors from having access to certain remedies, assuming that they value those protections more highly than their costs. If the marginal benefit to consumers of avoiding a particular remedy is larger than the marginal cost in terms of the higher price they must pay to compensate the lender for the heightened risk of loss, then the equilibrium level of credit and consumer welfare will be higher even if interest rates are higher.⁶⁴ As economists John Umbeck and Robert Chatfield describe the tradeoff:

The most significant cost of an additional remedy to the lender is the decline in the borrower's demand for a credit contract as the remedy shifts more of the risk to him. Wealth maximizing creditors will weigh the gains and costs of adding an extra remedy to a standardized contract and their resulting behavior is predictable through the use of an economic model.⁶⁵

sumers might be willing to pay a higher interest rate in some cases to be relieved of the risk of certain creditor remedies. For example, interest rates on secured credit are lower than unsecured credit because of the lender's enhanced collection rights on default. Notwithstanding this lower interest rate, a consumer might prefer to use unsecured credit for many purposes.

⁶⁴ For example, although eliminating a harsh remedy such as debtor's prisons might increase the risk of loss for lenders, it would also increase potential borrowers' demand for credit by freeing such borrowers from the risk of that severe consequence if they default. Access to personal bankruptcy similarly increases the risk (and cost) of lending while at the same time increasing the demand for credit. It is unclear as an *a priori* matter whether these offsetting adjustments will produce a higher or lower equilibrium level of credit.

⁶⁵ John Umbeck & Robert E. Chatfield, *The Structure of Contracts and Transaction Costs*, 14 J. MONEY, CREDIT & BANKING, 511, 513 (1982).

In a competitive market, leaving aside potential market failure issues, this analysis implies that lenders would voluntarily agree to exclude from their contracts the right to invoke remedies that borrowers wished to avoid, provided that the borrowers were willing to pay a higher interest rate to compensate for the increased risk of loss.⁶⁶ In a competitive market characterized by full information and low transaction costs, the end result would be to produce the efficient combination of price and collection terms for credit.

B. The Regulation of Collection Practices: An Economic Perspective

Given that, regulation will improve on the competitive market outcome only when (1) there is an identifiable market failure, and (2) a regulation can be implemented in practice that will address the market failure in a manner such that the benefits exceed the costs, including all unintended benefits and costs.

The effects of regulation on the terms of consumer credit, including remedies available on default, typically fall into two categories: intended and unintended effects. Intended effects are the easiest to observe; if legislators or regulators limit or prohibit a term or practice in a consumer credit contract, law-abiding lenders reduce their use of it. For example, where states place usury restrictions on the interest rates that creditors are permitted to charge on a loan, experience indicates that creditors do, in fact, abide by those limits and charge at or below the statutory maximum.⁶⁷

However, regulation of consumer credit terms often has several unintended consequences. Those unintended effects can generally be grouped under three headings: (1) term repricing, (2) product substitution, and (3) rationing, where debtors either lose access to cer-

⁶⁶ This analysis is oversimplified because it ignores potential problems of adverse selection and moral hazard, but it is intended to illustrate that at the margin lenders should be willing to trade off a willingness to surrender the right to invoke certain remedies as long as they are adequately compensated for the heightened risk of loss.

⁶⁷ See DURKIN ET AL., *supra* note 22, at 486-506.

tain types of credit or experience a reduction in credit lines and the amount of credit available.⁶⁸ *Term repricing* refers to the practice of offsetting any terms that are regulated below market levels by adjusting other terms of the contract to try to reestablish the equilibrium price and quantity. For example, lenders could respond to usury ceilings on interest rates by requiring a larger down payment or extending the loan maturity; for a credit card, the issuer could assess an annual fee.⁶⁹ *Product substitution* describes the evasion of credit regulations by shifting to products that are unequally regulated. For example, if consumers are unable to obtain credit cards because of regulatory limits, many consumers will turn to more expensive and less preferred alternatives such as payday loans or pawnshops. *Rationing* refers to the market adjustment that consumers experience from losing access to legal credit, generally as a result of regulation. The individual thereby may live without credit and its benefits, or may turn to alternatives such as illegal loan sharks. Reducing the supply of credit or making it more expensive does not eliminate demand. In the absence of a market failure that can be addressed by regulation, new regulation makes consumers worse off by forcing them to use different terms, products, and quantities from those they prefer.

Restrictions on creditors' remedies generally have the same effect as other types of regulatory controls on credit terms. Because making debt collection costlier and less effective raises the risk of lending, lenders would be expected to offset strict debt collection rules through a variety of adjustments. Those adjustments may include increasing interest rates, increasing the size of down payments, or inducing consumers to substitute alternative products that are less affected by restrictions on creditor remedies. For example, lenders might induce

⁶⁸ See Todd J. Zywicki, *The Market for Information and Credit Card Regulation*, 28 BANKING & FIN. SERVS. POL'Y REP. 13 (2009).

⁶⁹ See Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79 (2000); see also Robert L. Clarke & Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. BANKING & FIN. L. 235 (2013-2014).

high-income borrowers to shift from unsecured credit, such as credit cards, to secured credit, such as home equity lines of credit. Lower-income borrowers might be forced to shift from credit cards to products such as payday loans and pawn shops. Alternatively, lenders will ration access to credit, resulting in an overall decrease in the quantity of credit. Such rationing is done by cutting off lending to higher-risk borrowers or reducing the size of credit lines for all consumers. As economist Douglas Greer summarized in the conclusions of the National Commission on Consumer Finance studies in the 1970s:

When an important sanction is prohibited or significantly restricted, creditors compensate for the increased risk burden they consequently carry by introducing more stringent standards of applicant acceptability and/or raising rates of charge. In connection with sales credit this also means that larger down payments will be required and perhaps shorter maturities as well. Although virtually all consumers would be thus affected by such market changes, the most greatly affected would be the relatively poor and least credit worthy, so if such restrictions or prohibitions are imposed for the sake of these latter people, it is not self-evident that they will gain a net benefit by such action. It follows that the credit problems of the poor and those subject to cyclical unemployment are not necessarily solved by the curtailment of collections sanctions⁷⁰

Subsequent empirical studies have confirmed the observation that prohibiting creditors from using useful remedies in the event of default typically results in higher costs and less access to credit, with higher-risk bor-

⁷⁰ Douglas F. Greer, *Creditors Remedies and Contractual Provisions: A Legal and Economic Analysis of Consumer Credit Collections*, in 5 TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 154 (1973).

rowers being affected most. For example, a 1983 study by Barth, Gotur, Manage, and Yezer examines account-level data on unsecured personal loans originated by nine large consumer finance companies that accounted for about 40% of personal lending by finance companies at that time.⁷¹ The study finds a correlation between access to collection remedies and interest rates: interest rates are lower when certain remedies are permitted, and higher when they are not. Moreover, the statistical effect is continuous in nature, meaning that both the size and the availability of the allowed remedies, such as the allowed size of late fees or garnishments, matter as well.

In a follow-up study of 5,000 personal loans, Barth, Cordes, and Yezer confirm the initial findings regarding the economic effects of restricting creditors remedies. In this study, having fewer legal restrictions on available remedies was associated with a lower interest rate.⁷² Moreover, the study finds that although consumers express a willingness to pay higher prices for credit to exclude certain creditor remedies on default, the amount that they are willing to pay to avoid those remedies is smaller than the amount that creditors would raise prices in response to losing useful collection powers. For example, Barth et al. estimate that for every dollar reduction in the size of allowable late fees, lenders will increase the annual percentage rate (APR) on the loan by 2.2 percentage points; however, borrowers will value a dollar reduction in late fees at only 0.045 percentage points.⁷³ Also, consumers are willing to pay an APR that is 0.0045 percentage points higher in exchange for a ten-dollar reduction in the allowed garnishment amount; however, the authors estimate that creditors will increase the APR by 0.65 percentage points for each ten-dollar reduction in allowed garnishment.⁷⁴ Thus, Barth et al. find

⁷¹ James R. Barth et al., *The Effect of Government Regulation of Personal Loan Markets: A Tobit Estimation of a Microeconomic Model*, 38 J. FIN. 1233 (Sept. 1983).

⁷² James R. Barth, Joseph J. Cordes & Anthony M. J. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J.L. & ECON. 357 (1986).

⁷³ *Id.* at 377.

⁷⁴ *Id.*

that although borrowers might be willing to pay higher costs for credit to restrict certain creditor remedies, those amounts are often statistically insignificant and very small—much smaller than the size of the price increases that creditors require to compensate for loss of access to those remedies. The findings suggest that because the value that borrowers place on avoiding the remedies is less than the price of excluding them, creditors act efficiently to retain access to those particular remedies in their contracts, and state regulations that limited access to the remedies cost borrowers more than they want to pay.

A study published by William Dunkelberg in 1978 finds evidence that stricter regulation of creditor remedies results in higher prices and lower levels of credit for consumers.⁷⁵ In 1973, the state of Wisconsin enacted the Wisconsin Consumer Act (WCA), which, among other things, imposed substantial new limits on the remedies available to creditors on a consumer's default. Many of these limits anticipated the FTC's credit practices rule, which had been proposed but not finalized at that point. The WCA contained several provisions related to creditors' remedies, including limits on wage garnishment and credit insurance, prohibitions on wage assignment and the recovery of certain creditor collection costs such as attorneys' fees, limits on seizure of collateral without an opportunity for judicial process, and prohibitions on the taking of a non-purchase-money security interest in household goods to secure any loan of less than \$1,000.⁷⁶

Dunkelberg sent surveys to several hundred banks following the enactment of the WCA to see whether the Act changed any elements of the banks' lending behavior.⁷⁷ He reports that 46% of the banks he surveyed indicated that they had changed their lending policies in the period since the enactment of the law.⁷⁸ Dunkelberg states that the banks responded to the regulations in a number of ways. Of those that changed their lending pol-

⁷⁵ William C. Dunkelberg, *Banks Lending Response to Restricted Creditor Remedies* (Credit Research Ctr. Working Paper No. 20, 1978).

⁷⁶ *Id.* at 56, appendix D (summarizing terms of the WCA).

⁷⁷ Of these banks, 186 responded to the survey. *Id.* at 8.

⁷⁸ *Id.* at 9.

icies, 41% said that they had tightened credit standards, making fewer loans to "marginal borrowers." Twenty percent restricted loan maturities or the type or size of loans available. For example, because the WCA increased the costs of collection, some banks discontinued making small loans. Some of the costs of servicing delinquent loans do not vary proportionally with loan size—that is, the cost of making a phone call or drafting a letter is more or less the same for a loan of \$200 or \$2,000. As a result, if collection costs increased, there would be some minimum loan value amount below which it would not be economical to collect in the event of default. Alternatively, banks would cease making small loans to riskier borrowers, which some banks did as well. Some banks stopped making loans for household goods in response to new limits on the ability to seize collateral. Moreover, 11% of respondents said that they had increased interest rates, fees, or other costs such as down payment requirements. Although the general economic conditions and high interest rates of the early 1970s contributed to those policy changes, a majority—or in some instances a substantial minority—of banks identified the regulatory changes as a primary cause of their changes.

As Dunkelberg summarizes his findings:

The focus of this study has been the response of banks to lending regulations. The ultimate concern, however, is not the impact on banks, but on consumers who own and use banks, and in particular, on those who borrow from banks. Based on the reported changes, consumers found that (at least some) rates were higher or terms were less favorable, that some types of loans (collateralized, especially on household goods) were harder to obtain (some banks discontinued particular loan types, forcing customers to search elsewhere), and that it was harder to qualify for a loan. Not all customers were affected equally, the "marginal" borrower being most likely affected by higher rates and higher credit standards.

The debtor with payment difficulties presumably found things a little easier (although, [with] weaker remedies, lenders may initiate collection efforts sooner in order to avoid a more serious delinquency). The time between default and repossession was increased, leaving the consumer with the use of the item in question for a longer period. The delinquent debtor was no longer liable for many legal fees. In more cases, the lender may have given up collection of the debt, especially if the . . . expected recovery was small compared to expected legal fees. [This] resulted in a transfer of wealth to the delinquent debtor.⁷⁹

A recent study by economist Viktor Fedaseyeu confirms the standard economic analysis that mandatory restrictions on creditor collections have an overall adverse effect on consumers' access to credit.⁸⁰ Fedaseyeu created a database that rates the strictness of states' collection laws and the effect on access to consumer credit in each state. He finds that stricter regulation of third-party debt collectors results in a lower level of credit card collections in each state (9% lower on average for each additional restriction on debt collection activity) and that this circumstance leads to a decrease of 2.2% in the number of new revolving lines of credit for consumers.

Although the details of some of those studies are dated, they point out the timeless economic warning that careful cost-benefit analysis is needed before undertaking efforts to impose new regulations on collections. Consumers in default might benefit from restrictions on certain remedies (although, as will be discussed, even this outcome is not obvious), but all consumers will end up paying higher prices for credit and gaining less access

⁷⁹ *Id.* at 29.

⁸⁰ Viktor Fedaseyeu, *Debt Collection Agencies and the Supply of Consumer Credit* (Fed. Reserve Bank of Phila., Working Paper No. 13-38, 2013).

to credit, especially higher-risk and lower-income consumers. This admonition is especially pressing today because the effect of additional regulations combined with earlier generations of similar regulations will be cumulative. Given that earlier regulatory vintages captured much of the "low-hanging fruit" of limitations that were most likely to have a net positive effect for consumers and the economy, the CFPB should proceed carefully to ensure that the marginal benefits of its regulations exceed the marginal costs.⁸¹

C. *The Effects of Debt Collection Regulation on Higher-Risk Borrowers*

Inefficient regulation of creditor remedies can also have distributive effects. As Dunkelberg notes in his study, higher-risk borrowers are most adversely affected by the higher interest rates and stricter lending standards imposed by lenders in response to tighter limits on debt collection.⁸² Hynes and Posner note another regressive distributional effect: restrictions on remedies affect unsecured credit more severely than they do secured credit, which increases the cost to consumers of unse-

⁸¹ It is theoretically possible that some restrictions on creditor's remedies can be efficient for some consumers in some contexts. For example, Villegas finds that restrictions on some remedies are associated with an increase in both the likelihood that a given consumer will have access to credit and the likelihood that a higher overall quantity of credit will be available. Daniel J. Villegas, *Regulation of Creditor Practices: An Evaluation of the FTC's Credit Practice Rule*, 42 J. ECON. & BUS. 51 (1990). But he also finds that restricting other remedies has a negative impact on the amount of credit outstanding. Thus, even though Villegas finds that some restrictions can increase consumer demand more than they reduce lender supply, his results are mixed. Moreover, the implications of Villegas's positive findings may not be replicable in the current regulatory environment. Collection remedies are much more highly regulated today than they were at the time of his study. Indeed, the remedies that Villegas's study finds it efficient to regulate (nonpurchase money security interests in household goods and garnishment) are now regulated; the task of identifying *additional* regulations for which the benefits to consumers exceed the costs will be very difficult.

⁸² See Dunkelberg, *supra* note 74, and accompanying text.

cured credit relative to secured credit.⁸³ High-income consumers are more likely to have access to assets that can provide collateral for loans, such as home equity loans. Creditors might also require cosigners before making a loan, a requirement that might further favor borrowers from higher-income backgrounds. As a result, high-wealth and high-income borrowers may be able to avoid the higher costs that accompany stricter limits on creditor remedies by increasing their use of secured credit.⁸⁴ Low-income consumers, by contrast, will likely be forced to turn to products such as payday loans and pawnshops to meet their credit needs. In fact, reducing access to credit by higher-risk borrowers could even benefit lower-risk borrowers by increasing the supply of lending capital available for loans to them.⁸⁵

In addition, there may be distributional consequences among borrowers who have different subjective and heterogeneous preferences with respect to the types of remedies that they are willing to accept on default. For example, some consumers may be more tolerant or may find different practices and remedies more useful than others.⁸⁶ Moreover, some borrowers simply place a higher value in general on protection from creditor remedies than do others. More important, research indicates that borrowers who do place a higher value on restricting creditor remedies are willing to compensate the lender for the higher risk incurred by, for example, paying a

⁸³ Hynes & Poser, *supra* note 27.

⁸⁴ Fedaseyeu finds that although stricter regulatory limits on creditors' remedies are associated with a reduction in access to unsecured debt, the limits have no effect on secured debt, consistent with the theory that access to creditor remedies is more important for unsecured debt than for secured debt. *See* Fedaseyeu, *supra* note 79, at 21. However, he does not directly test for a substitution effect between unsecured and secured debt, because he examines changes in auto loans and mortgages, neither of which seem to be close substitutes for credit card debt (as compared with a product such as a home equity line of credit, which appears to be a closer substitute). Thus, it is not clear that his findings are inconsistent with the predicted effect of increased substitution to secured debt over time.

⁸⁵ *See* DURKIN ET AL., *supra* note 22, at 533.

⁸⁶ *See* Gregory A. Falls & Debra Drecnik Worden, *Consumer Valuation of Protection from Creditor Remedies*, 22 J. CONSUMER AFF. 20 (1988).

higher interest rate or a higher down payment, or by adjusting other terms of the contract.⁸⁷ Regulatory restrictions on collections, however, typically take the form of mandatory rules that the parties cannot alter by contract; thus, even if borrowers agreed to permit access to a particular remedy, in exchange for a lower interest rate, for example, they would be prohibited from doing so. As a result, consumers who are more sensitive to intensive debt collection can force those who are less sensitive to subsidize their preferences.

To the extent that the willingness to pay for such restrictions reflects a higher subjective willingness to default, the restrictions limit the ability of relatively low-risk borrowers to signal their creditworthiness and thus create a pooling equilibrium among relatively lower-risk and higher-risk borrowers. As a result, lower-risk borrowers subsidize higher-risk borrowers. In turn, the limitation on the ability of lower-risk borrowers to signal their relatively creditworthy status and to be rewarded through lower costs of borrowing can drive those consumers out of the relevant market as they substitute other products, such as secured credit, for which the distorting effects of the regulation are not as costly.

V. MARKET FAILURE ARGUMENTS FOR REGULATION OF CONSUMER DEBT COLLECTION

As noted, regulation typically is thought to be justified in consumer credit markets in which (1) there is an identifiable market failure, and (2) a regulation can be implemented in practice that will address the market failure in such a manner that the benefits exceed the costs, including all unintended benefits and costs.

Several theories of market failure assert why contracting between consumers and lenders may be prone to market failures that harm consumers. In contrast, both theoretical arguments and empirical evidence cast doubt on the theoretical claims of market failures. Moreover, empirical evidence suggests that many interventions impose costs on consumers that exceed their benefits—

⁸⁷ *Id.*

perhaps reflecting the absence of a market failure in the first place.

A. Possible Market Failures in Consumer Credit Contracts

Advocates of stricter regulation of creditor collection practices identify several claimed market failures in the debt collection market that they believe support heightening regulation. Many of these arguments made today reprise arguments made in the past, most notably in the context of promulgating the FTC's credit practices rule in 1985.⁸⁸ Therefore, although very few rigorous studies of the effect of regulation of debt collection have been made in recent years, most of the key issues in today's debates have been the subject of extensive study in the past.

In connection with issuing the credit practices rule, the FTC identified three sources of potential market failure in contracting between consumer borrowers and lenders over remedies.⁸⁹ First, the FTC argued that regulation of debt collection practices can potentially redress problems of unequal bargaining power in consumer credit markets, which supposedly allow lenders to propose "contracts of adhesion" that force borrowers to accept contracts with harsh remedy provisions on a take-it-or-leave-it basis. Second, the FTC argued that regulation is supposed to protect borrowers who lack a full understanding of or information about the terms of collection in their contracts. Third, the FTC argued that adverse selection may occur. According to this argument, competition forces creditors to offer only loans with harsh remedy terms because lenders who offer less harsh terms will disproportionately attract higher-risk borrowers, a situation that, in turn, will lead to higher loss rates.

⁸⁸ See FTC staff, *Unpublished Memorandum to Commissioners from the Division of Special Projects, Bureau of Consumer Protection, in SUPPORT OF A TRADE REGULATION RULE TO LIMIT CREDITORS' REMEDIES* 30-43 (1974). Although the rule was not finalized until 1985, consideration began a full decade earlier.

⁸⁹ Additional purported market failures are alleged to be unique to third-party debt collectors and debt buyers and are distinct from these general concerns. Those arguments will be treated separately.

Higher losses will then force lenders to charge higher interest rates and consequently drive away low-risk borrowers. Therefore, a lender that offers lenient default terms will attract only higher-risk borrowers, leading to an unraveling of its customer risk pool. To prevent this situation, each lender will insist on default and collection terms that are relatively harsher than its competitors' terms. However, because each lender has the same incentive, it is feared that all lenders will converge on the harshest set of terms, even if those terms are more aggressive than the terms that lenders and borrowers would actually prefer. Thus, the uncoordinated activity of creditors might produce a market equilibrium composed of inefficiently harsh terms that actually reduce the overall volume of credit because the reduction in consumer demand exceeds the supply-side effects of reduced lending losses.⁹⁰

An analysis of each of the three purported theoretical rationales for regulation exposes the problems in each and illustrates the need for caution and careful cost-benefit analysis before imposing new regulations. The following analysis will focus on the first two rationales because they are more commonly advanced today as arguments for regulation: that consumers are forced to accept unfair terms regarding collections because they hold unequal bargaining power on a take-it-or-leave-it basis and that consumers are not fully aware of the remedies available to creditors because they lack information or fail to pay attention.

In justifying the credit practices rule, the FTC asserted that the imbalance in bargaining power between creditors and borrowers meant that consumer lenders uniformly demanded that borrowers permit them to use all remedies permitted under law. As the FTC wrote, "[t]he contracts reflect each company's undeviating policy of laying claim to all possible contractual remedies. The industry's unitary approach to this matter precludes

⁹⁰ Note that the second and third theoretical rationales for regulation are mutually contradictory, because the adverse selection rationale for regulation is predicated on the assumption that borrowers are aware of and base their borrowing decisions in part on the default terms offered by competing lenders.

any consumer so disposed from shopping for a loan agreement which dispenses with harsher remedies.”⁹¹ In addition, the FTC asserted that every consumer credit contract “contains a complete catalogue of any and all contractual devices.” It continued, “[t]he extent to which the creditor arms himself with collection tools depends in no way on any knowledge he may have gained concerning the particular circumstance of a given debtor; the complete inventory of remedies is recited in every contract, and they are completely nonnegotiable.”⁹² The FTC provided no evidence to support those factual claims.

The CFPB’s Debt Collection ANPR echoes the FTC’s arguments, focusing mainly on the claim that consumers lack adequate information about collection terms in contracts. Although consumers might pay attention to certain terms of their contracts, such as the interest rate, the CFPB argues that they might not pay adequate attention to contract terms governing default and collections. The CFPB states:

Typically, competition in markets will incentivize firms to provide products and services on terms that consumers favor, but this competition may not be effective with regard to collections practices. . . . If firms’ collection practices—or the practices of third-party collectors employed by the creditors or the buyers to whom creditors sell debt—played an important role in consumers’ borrowing or purchasing decisions, then this competition would impose some discipline on firms to reduce overly aggressive tactics. When consumers make borrowing or purchasing decisions, however, they may not be focused on the risk that they will default.⁹³

That lack of attention could enable lenders to exploit consumers by imposing stricter collection terms than

⁹¹ FTC staff, *supra* note 87, at 16-17.

⁹² *Id.* at 36. The FTC’s report was highly controversial at the time and spawned substantial study to assess its claims. See Letsou, *supra* note 23, at 614-15.

⁹³ FTC staff, *supra* note 87, at 36.

consumers would agree to if they were fully informed. If so, then regulation could theoretically improve consumer welfare by addressing that market failure.

B. Economic Analysis of Market Failure Arguments

Despite the intuitive appeal of the CFPB's arguments, theoretical and empirical evidence do not support the conclusion that market failure is present with respect to debt collection remedies. Moreover, because they track arguments made by the FTC in the past, many of the claims have already been studied by economists.

1. Theoretical Analysis with Market Failure Arguments

Consider first the argument that consumer credit contracts are contracts of adhesion that are offered to consumers on a take-it-or-leave-it basis. This argument is problematic on several levels. For one thing, it suggests that *all* terms of a consumer credit contract should be dictated by lenders, not just collection terms. Yet interest rates and other terms on consumer loans are set by the forces of supply and demand and are not dictated to consumers by creditors.⁹⁴ If lenders do possess bargaining power over borrowers, it is not clear why they would use that power only to oppress the small number of consumers who default rather than using their alleged power to oppress all borrowers through higher interest rates or other loan terms. In short, as a theoretical supposition, the argument that consumer credit contracts are contracts of adhesion does not hold together because it fails to explain why an imbalance in bargaining power would be exercised only with respect to the collection terms of the contract.

To distinguish remedies terms from other terms of a consumer credit contract, such as the interest rate, therefore, one must turn to the argument stressed by the CFPB that consumers do not pay adequate attention to collection terms, focusing instead on other terms of the contract, such as interest rates. In modern parlance, in-

⁹⁴ See DURKIN ET AL., *supra* note 22, at 509-11 (summarizing studies).

terest rate terms are said to be “salient” to consumers, and therefore are terms that they notice, understand, and take into consideration in their decision making. Collection terms, however, are claimed to be not salient and thus do not receive sufficient attention and consideration from consumers when they shop among competing credit offers.⁹⁵ If this distinction between salient and non-salient terms were valid, then creditors could exploit consumers by imposing harsh collection terms without the borrowers knowing about those terms. In that case, the terms would perform no risk-based pricing function in the contract but would operate solely to redistribute wealth from ignorant consumers to lenders. If so, a corollary implication would be that banning or restricting access by creditors to certain terms could provide increased protection for consumers without a compensating increase in price or restriction in credit access.

However, the theoretical argument that low consumer awareness produces a market failure is flawed for at least two reasons. First, as noted, empirical evidence overwhelmingly demonstrates that when access to collection remedies is restricted, prices, such as interest rates and down payments, increase and the overall equilibrium quantity of credit declines. That there is a supply effect in response to those limits suggests that lenders view those terms as performing a risk-pricing function, and that when such terms are prohibited, lenders adjust other terms of the contract. If, however, the terms were inserted without any awareness by consumers, it would follow that no change would be made to interest rates or quantity supplied.

Second, economists have long understood that it is not necessary for every consumer to be aware of and to shop on particular terms in a contract for the market to

⁹⁵ See Thomas A. Durkin, Gregory Elliehausen & Todd J. Zywicki, *An Assessment of Behavioral Law and Economics Contentions and What We Know Empirically About Credit Card Use by Consumers*, 22 S. CT. ECON. REV. 1 (2015) (describing and critiquing the theory of term salience in credit card contracts).

produce welfare-enhancing outcomes for consumers.⁹⁶ Few consumers know all of the attributes of a car, dishwasher, or television, yet market outcomes are generally assumed to be welfare enhancing, and prices are set competitively. Consumer decisions about credit cards or mortgages are not fundamentally different from decisions related to any other complex consumer product.

If sellers are unable to accurately distinguish among thorough shoppers, moderately informed shoppers, and consumers who do not shop around, all consumers need not be highly informed for an efficient outcome to result.⁹⁷ Firms that try to exploit low-information shoppers by offering inferior contracts will lose the business of informed customers; thus, a critical mass of consumers who actually do shop around will lead firms to offer the same contracts to all customers. Consumers who are informed provide a positive pecuniary externality to those who are not, essentially protecting not just themselves but also those who do not shop around. In fact, as few as one-third of consumers need to shop around for the market to generate a competitive equilibrium that benefits all consumers.⁹⁸ Moreover, although standard form contracts are often characterized as being unfriendly to consumers by limiting their ability to bargain over particular terms, Schwartz and Wilde argue that standard form contracts may benefit consumers by reducing origination costs, facilitating comparison

⁹⁶ See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983) [hereinafter Scharztz & Wilde, *Imperfect Information*]; Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979) [hereinafter Scharztz & Wilde, *Intervening in Markets*]. See also Steven Salop & Joseph Stiglitz, *Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersion*, 44 REV. ECON. STUD. 493 (1977); Louis L. Wilde, *Labor Market Equilibrium Under Nonsequential Search*, 16 J. ECON. THEORY 373 (1977); Michael Rothschild, *Models of Market Organization with Imperfect Information: A Survey*, 81 J. POL. ECON. 1283 (1973).

⁹⁷ DURKIN ET AL., *supra* note 22, at 524.

⁹⁸ See Schwartz & Wilde, *Intervening in Markets*, *supra* note 95.

among contracts, and making lender discrimination more difficult.⁹⁹

2. Empirical Analysis of Market Failure Arguments about Consumer Contracting

Empirical evidence also fails to support market failure theories about contract terms. In fact, creditors do not insist that contracts include all remedies permitted by law, as the FTC had asserted. In one of the technical studies performed for the National Commission on Consumer Finance in 1974, economist Douglas Greer reviews contracts provided by more than 1,000 providers of consumer financial services, including banks, finance companies, and retail stores.¹⁰⁰ Greer finds that credit contracts do not reserve blanket remedy provisions to lenders nor do all remedies appear to be required on a take-it-or-leave-it basis. He finds instead that contracts typically reserve only those remedies that lenders think are most effective, such as repossession of collateral for purchase-money consumer goods and payment of the lender's attorney's fees, and those remedies that consumers think are most acceptable. By contrast, remedies that are controversial and that consumers especially dislike, such as confession of judgment provisions, are rarely found in consumer credit contracts. Greer also finds wide variation among lenders in different industries as to the presence of certain remedies, and in fact, he even finds variation among different types of loans within a

⁹⁹ *Id.* See also Schwartz & Wilde, *Imperfect Information*, *supra* note 95.

¹⁰⁰ Douglas F. Greer, *An Empirical Analysis of the Personal Loan Market*, in 4 TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE (1974). Greer's analysis predated many of the modern consumer protection laws that have been enacted since; thus, his study includes several remedies that subsequently have been banned or restricted. What is relevant for the contemporary debate, however, is not the particular remedies that Greer studied, but the dynamics of the overall contracting process as to whether creditors uniformly require borrowers to contractually agree to permit the creditor all remedies available by law in the event of a default or instead whether the mix of remedies approximates those that consumers would willingly pay for.

given industry, rebutting the assertion that creditors universally demand blanket access to all remedies allowed by law.¹⁰¹ In addition, he finds that even when certain remedies are permitted by the contract, lenders do not typically avail themselves of all available contract remedies in practice. Thus, not only do creditors not insist on reserving their right to exercise all collection powers on default, but also, when actually collecting, they do not avail themselves of all the powers they preserved in the contract.

Economist Richard Peterson provides a general model of economic factors that generalizes Greer's findings.¹⁰² Peterson hypothesizes that although access to collection remedies provides a benefit to creditors by reducing losses and defaults, exercising those remedies has costs as well. He identifies three costs that restrain creditor behavior in bargaining for and later exercising particular remedies: (1) the costs associated with invoking a remedy; (2) forgone payments that the borrower would have voluntarily resumed; and (3) loss of goodwill, such as the loss of future business resulting from a reputation for using unduly harsh or overreaching creditor remedies.

Therefore, although intensive collection efforts benefit creditors by reducing their losses, direct and indirect costs from collecting debts and taking different types of actions will have different costs and benefits. Creditors will avail themselves only of those remedies for which the marginal benefits exceed the marginal costs. For example, although a single telephone call may be relatively inexpensive, it could have potentially large or small benefit in terms of facilitating recovery depending on the context. If, for example, a consumer simply has forgotten to pay a bill, a telephone call could be a

¹⁰¹ For example, in the study, acceleration clauses are more common for banks and finance company contracts than for retailers, but among retailer contracts, acceleration clauses are much more common for revolving credit contracts than for installment loans. *Id.*

¹⁰² See Richard L. Peterson, *Creditors' Use of Collection Remedies*, 9 J. FIN. RES. 71 (Spring 1986).

low-cost means of collecting by reminding the borrower that payment is due. In many other cases, however, a telephone call will be ineffective. By contrast, although a successful lawsuit would likely, in most cases, greatly facilitate collection, formal court proceedings are expensive and slow, and risk loss of goodwill to the lender.

In practice, both contracting and collection activities implicitly recognize this economic logic. Creditors pursue a sliding scale of collection practices and will invoke those remedies that have the highest net present value in terms of weighing the marginal benefits of exercising particular remedies against the cost of doing so. Collection actions will be taken only if the expected benefits exceed the expected costs.¹⁰³ Collection efforts thus will begin with the least expensive collection methods available, such as a letter or phone call, and then escalate to more intensive methods, such as a lawsuit or repossession of collateral, only if the expected marginal benefit of these more intensive collection methods exceeds the expected marginal costs. As Greer observes in his study for the National Commission on Consumer Finance:

The particular policy of creditors vary widely . . . but it seems safe to say that many if not most of them attempt to obtain payment in a stepwise process which employs the least costly means of personal contact first, followed by more and more costly techniques if the delinquency is enduring enough to cross each threshold of the pursuit."¹⁰⁴

In fact, the CFPB itself implicitly recognizes the continued relevance of this dynamic, noting for example that for small-dollar debts, such as utility, medical, or telecommunications bills, even contacting the consumer may not be cost-effective, stating, "consequently some collectors simply report these items to consumer reporting

¹⁰³ See Richard M. Hynes, *Broke but Not Bankrupt: Consumer Debt Collection in State Courts*, 60 FLA. L. REV. 1, 56-60 (2008).

¹⁰⁴ Greer, *supra* note 69, at 151.

agencies (CRAs) and wait for the consumer to contact the collector after discovering the item on a credit report."¹⁰⁵

Peterson also finds that consumers hold strong opinions about collection practices, and those practices that consumers consider most acceptable tend to match those that Greer identifies as most effective for lenders.¹⁰⁶ Conversely, most of the remedies that lenders consider ineffective are among those that consumers dislike most, such as nonpurchase money security interests in household goods, wage assignments, and confession of judgment. If lenders find a remedy to be effective but disliked by consumers, they use the remedy infrequently, reflecting solicitude for consumer preferences. In a conclusion that continues to resonate today, Peterson states:

The results suggest that state and federal legislators who consider restricting creditor practices in the future must determine whether they are attempting to correct a problem that is more apparent than real. . . . Legislators must also ask themselves if the restriction of credit practices useful to lenders will add sufficiently to the social welfare to compensate for the reduction to consumers of the quantity of credit available.¹⁰⁷

C. Potential Unintended Consequences of Regulating Debt Collection Practices for Delinquent Consumers

Because creditors exercise their remedies in this stepwise and economically predictable fashion, regulation of collection practices can potentially have unintended consequences for consumers that go beyond the macro considerations of the effects on access to credit. Regulation interrupts the organic process of gradual escalation of the use of various remedies, thus harming consumers by potentially leading creditors to use more expensive and more intensive collection practices.

¹⁰⁵ Debt Collection (Regulation F), *supra* note 1, at 67850.

¹⁰⁶ Peterson, *supra* note 101, at 85.

¹⁰⁷ *Id.*

1. Unintended Consequences of Regulating Debt Collection Practices

The fact that creditors escalate debt collection practices according to a sliding scale implies a corollary proposition: if lighter-touch and less expensive collection efforts, such as telephone calls or written contacts, are restricted or prohibited, creditors and collectors will escalate their collection efforts more rapidly to more intensive and more expensive collection techniques such as lawsuits. Indeed, some consumer groups have asserted that the volume of litigation by creditors to collect debts has increased in recent years.¹⁰⁸ Two possible reasons might be heightened regulation and declining efficacy of lower-cost extralegal efforts to collect debts. For example, creditors may have difficulty contacting consumers who have moved away from using traditional mail and landline telephones for their communications.

Restrictions on particular remedies will have distributional consequences as well. Different types of lenders rely on different collection practices. For example, collection of larger debts, such as credit card debts, may justify escalation to more expensive collection methods, whereas collection of smaller debts, such as utility bills, may not. Regulation that limits the availability of less intensive means of collection and leads to rapid elevation of more intensive and expensive procedures will thus have a disproportionate negative impact on creditors whose products and services tend to result in many small unpaid debts rather than larger debts, whose collection justifies more expensive collection processes.

In addition, if small loans become uneconomical to collect because of restrictions on low-cost collection practices, then lenders also will likely respond by curtailing their willingness to make small loans. Indeed, Dunkelberg observes this behavior in his study of Wiscon-

¹⁰⁸ LISA STIFLER & LESLIE PARRISH, *The State of Lending in America & its Impact on U.S. Households*, in DEBT COLLECTION & DEBT BUYING 9 (Center for Responsible Lending, April 2014).

sin's consumer protection act. In the study, many lenders reported that they would stop making smaller loans in response to the increase in the costs of collecting relative to the size of the loan.¹⁰⁹ In such a scenario, some borrowers who qualify to borrow only small sums will lose access to credit completely or will shift to alternative types of loans such as payday loans. Others will be forced to borrow a larger sum than they prefer, which will raise their risk of subsequent default.¹¹⁰

2. Unintended Consequences of Interactions of Limits on Collections with Substantive Regulations

Estimating the expected costs and benefits of debt collection regulations is especially difficult because the precise nature and magnitude of unintended consequences will depend not just on the rules governing debt collections, but also on the interaction of debt collection rules with other substantive rules, such as usury restrictions, that limit maximum interest rates. Because substantive regulations, such as usury ceilings, vary from state to state, the complexity of those interactions is especially important for federal regulators to consider.

For example, the unintended adverse effects for consumers of limits on creditor remedies will be larger when those rules are accompanied by usury ceilings on interest rates.¹¹¹ Lenders can address the risk of lending either by reducing their expected losses from default or by increasing the price of credit to offset higher expected

¹⁰⁹ Dunkelberg, *supra* note 74.

¹¹⁰ See THOMAS A. DURKIN, GREGORY ELLIEHAUSEN & MIN HWANG, RATE CEILINGS AND THE DISTRIBUTION OF SMALL DOLLAR LOANS FROM CONSUMER FINANCE COMPANIES: RESULTS OF A NEW SURVEY OF SMALL DOLLAR CASH LENDERS (Dec. 2, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2533143 (noting that the average loan size for personal finance loans is higher in states with lower APR ceilings).

¹¹¹ See William C. Dunkelberg & Robin De Magistris, *Measuring the Impact of Credit Regulation on Consumers*, in THE REGULATION OF FINANCIAL INSTITUTIONS 44 (Fed. Res. Bank of Boston, Conference Series 21, 1979).

losses. As a result, more vigorous collection efforts *ex post*, to reduce losses, or higher interest rates *ex ante*, to compensate for expected losses, are substitutes for each other. In a competitive market, borrowers and lenders would agree to the efficient combination of default and price terms that would maximize the gains to trade between them, trading off default and price terms at the margin and reaching the efficient quantity of credit. Where regulation limits, for example, maximum interest rates, the distortion of consumer credit markets can be offset to some extent by using more intensive collection efforts after default. Similarly, where remedies are limited, creditors can raise interest rates or adjust other terms of the contract to compensate for increased losses and delay in collection. Where, however, a state restricts both remedies and prices simultaneously, those adjustments are constrained, and a larger reduction in access to credit will result.¹¹²

VI. THE ROLE OF THIRD-PARTY DEBT BUYERS AND DEBT COLLECTORS

Debt collection law traditionally has regulated third-party debt collectors more stringently than it regulates lenders seeking to collect their own debts. For example, by its terms the Fair Debt Collection Practices Act applied only to third-party debt collectors, not to originating creditors.¹¹³ Most states also impose additional regulations that specifically apply to third-party debt collectors.¹¹⁴

The CFPB argues that third-party debt collectors and debt buyers may be prone to a unique type of market failure distinct from that claimed about creditors generally. Namely, if the debt is sold or assigned to a third party for collection, consumers have no ability to shop for or choose the collector of their debt as they did

¹¹² Peterson, *supra* note 101.

¹¹³ For a summary of the rationales for this limitation, see Hunt, *Collecting Debt*, *supra* note 25, at 19-20.

¹¹⁴ *Id.* at 21.

for the original credit provider. Thus, whereas a consumer, at least in theory, could take into account the reputation of the original lender in deciding to enter into a contract—and could refuse to deal with that lender in the future if he or she felt abused—the consumer has no such power with a third-party collector. The CFPB argues that this inability to exercise control over one's debt collector produces a market failure that suggests the propriety of regulation. As the CFPB contends,

While debt collection can benefit consumers by reducing the price and increasing the availability of credit, in the absence of legislation and regulation many consumers may be subject to debt collection efforts that raise consumer protection concerns. Typically, competition in markets will incentivize firms to provide products and services on terms that consumers favor, but this competition may not be effective with regard to collections practices. Once a debt has gone into collection, consumers cannot choose their collector; the relevant choice for the consumer came when deciding from which firm to purchase or borrow. If firms' collection practices—or the practices of third-party collectors employed by the creditors or the buyers to whom creditors sell debt—played an important role in consumers' borrowing or purchasing decisions, then this competition would impose some discipline on firms to reduce overly aggressive tactics. When consumers make borrowing or purchasing decisions, however, they may not be focused on the risk that they will default. As a result, a consumer's decision to obtain credit from a particular creditor is unlikely to be influenced by the identity of the collector that might eventually collect on the debt if the consumer defaults. Indeed, it is unlikely that the consumer and perhaps even the creditor could know the identity of the future third-party collector. Firms therefore have a limited incentive to engage in less aggressive tactics if those tactics lead to increased recovery of debts. This effect may be exacerbated in the case

of third-party collectors or debt buyers if consumers do not associate their treatment by the collector or debt buyer with the original creditor.¹¹⁵

CFPB Director Richard Cordray also has argued that consumers are particularly vulnerable to overreach by third-party collectors because the inability to choose one's debt collector eliminates market checks on bad behavior:

When consumers have limited clout because they do not choose the businesses they must deal with, they lack the ultimate control of being able to sever their ties. This is true even though what goes on in those markets can have a profound influence on their lives. Take, for example, debt collection.¹¹⁶

Both the CFPB and Cordray ground their argument in the assumption that because consumers are unable to choose who collects their debts, no market checks are in place to restrain overreach by collectors. The fact that consumers do not choose their debt collectors directly, however, does not mean that debt collectors face no market restraints on overreaching behavior. Although consumers cannot sever their ties from those seeking to collect debts from them, originating lenders who sell or assign those debts can. Further, to the extent that customers are aware of the identity of the creditor originating the debt, consumers will blame the original lender for the actions of the assignee, at least to some extent. Indeed, this point is illustrated by the OCC's observation in issuing risk management guidance to national banks and federal savings associations that the sale of accounts to debt buyers raises a potential for reputational risk to the bank.¹¹⁷ The comptroller observes:

¹¹⁵ Debt Collection (Regulation F), *supra* note 1, at 67849.

¹¹⁶ Richard Cordray, Dir., CFPB, Remarks at the National Baptist Convention, USA, Charlotte, NC (Sept. 5, 2013), (transcript available at <http://www.consumerfinance.gov/newsroom/director-cordray-remarks-at-the-national-baptist-convention/>).

¹¹⁷ See OCC BULL., *supra* note 54.

Banks should be keenly aware that debt buyers pursue collection from former or current bank customers. Even though a bank may have sold consumer debt to a debt buyer, the debt buyer's behavior can affect the bank's reputation if consumers continue to view themselves as bank customers. Moreover, abusive practices by debt purchasers, and other inappropriate debt-buyer tactics (including those that cause violations of law), are receiving significant levels of negative news media coverage and public scrutiny. When banks sell debt to debt buyers that engage in practices perceived to be unfair or detrimental to customers, banks can lose community support and business.¹¹⁸

This check might be an even more powerful constraint on debt buyers and debt collectors than consumer dissatisfaction, because many originating creditors will be sellers of multiple accounts. Thus, actions that alienate customers against the originating creditors could provoke termination of the stream of business.

Moreover, the concern of lenders about the impact on their reputations from the actions of third-party debt collectors is not merely theoretical. Many major creditors, including Wells Fargo, have announced that they will sell their debt *only* to debt buyers that meet the certification standards of the DBA International, a debt-buying industry trade group that certifies members on the basis of their compliance with certain minimum standards and ethics.¹¹⁹

Furthermore, third-party debt collectors and debt buyers provide value to the debt collection process in these ways: (1) they provide expertise in the collection of debts to reduce loss rates and the cost of collecting, (2) they provide liquidity to the consumer credit system, and (3) they provide an efficient level of debt collection activity in situations in which originating creditors are unwill-

¹¹⁸ *Id.* at 2.

¹¹⁹ Telephone Interview with Steve Dostal, Wells Fargo.

ing or unable to do so.

First, third-party debt buyers and debt collectors provide expertise in collections that will reduce costs of recovery and bad debt losses.¹²⁰ Collection of debts from delinquent consumers is a discrete stage in the consumer credit system, and lenders that are primarily focused on effectively underwriting loans on the front end of the process or even on servicing their performing loans will not necessarily also be experts in collecting nonperforming debts. The benefits of specialization are especially obvious with respect to medical debts or student loans, in which the consumer's debt is often originated with little or no underwriting. By specializing in the unique methods of collecting nonperforming debt, debt collectors may be able to reduce lenders' losses on uncollectible debt at lower cost than the lenders could themselves. Third-party collectors may also have comparative expertise and flexibility in structuring realistic payment arrangements that meet the constraints of the consumer's budget and may use other flexible practices that increase recovery at lower cost.

Second, third-party debt collectors and debt buyers increase liquidity in the consumer credit system. This is most obvious in the case of debt buyers. By selling distressed debt, lenders can convert nonperforming debt into liquid assets that can be used productively.¹²¹ Debt collectors, which typically are paid on a contingency fee basis, permit creditors to recover some of what is owed

¹²⁰ See Debt Collection (Regulation F), *supra* note 1, at 67849 ("Third-party collectors may possess capabilities and expertise in collections that the creditors' in-house operations lack."). Moreover, as the CFPB notes, third-party collectors are often paid on a contingency fee basis, which enables the original creditor to recover some of what is owed without having to make up-front resource investments. See *id.*

¹²¹ See OCC BULL., *supra* note 54, at *1 ("The OCC recognizes that banks can benefit from debt-sale arrangements by turning nonperforming assets into immediate cash proceeds and reducing the use of internal resources to collect delinquent accounts. In connection with charged-off loans, banks have a responsibility to their shareholders to recover losses.").

without having to make up-front resource investments.¹²²

Third, third-party debt collectors may provide a solution to what would otherwise be a market failure if creditors were required to collect their own debts. Namely, originating creditors might in some cases be insufficiently intensive in collecting debts, leading to inefficiently high losses. Although third-party debt collectors are unlikely to be completely immune from any concerns about goodwill because of the potential for their activities to be imputed by the consumer to the originating lender, third-party debt collectors may be *relatively* less limited by such extralegal constraints than are originating creditors. Although in some instances those weaker extralegal checks can result in overly intensive debt collection methods, in other contexts the presence of third-party debt collectors can create an optimal level of debt collection activity if the originating creditor is overly reluctant to engage in such practices for goodwill and reputational concerns.

In a competitive market, losses from uncollected debts are passed on to other consumers in the form of higher prices and restricted access to credit; thus, excessive forbearance from collecting debts is economically inefficient. Again, as noted, collection activity has an effect on both the supply and the demand of consumer credit. Although lax collection efforts will increase the demand for credit by consumers, the higher losses associated with lax collection efforts will increase the costs of lending and thus raise the price and reduce the supply of lending to all consumers, especially higher-risk borrowers. The overall economic effect of reputational concerns on collection activity is thus ambiguous: although reputational concerns can deter inefficiently harsh economic collection activity (practices in which the costs to consumers outweigh the benefits), those same concerns in some instances can also deter otherwise *efficient* collection activity as well, leading lenders to inefficiently reduce supply and raising costs for other consumers, thus

¹²² Debt Collection (Regulation F), *supra* note 1, at 67849.

creating deadweight loss. In that case, the ability to assign certain debts to third-party debt collectors might correct an inefficiency by promoting more intensive debt collection efforts.

The historical experience of retail lending to consumers is suggestive. Historically, retailers provided credit to consumers to facilitate purchase of the retailer's wares. But because the borrowers were also store customers, the primary benefits to retailers of offering credit were to promote customer loyalty and to sell merchandise.¹²³ Indeed, retail credit operations typically operated at a loss to subsidize the retail function of the store.¹²⁴ Because using more intensive collection measures would have disrupted their ongoing relationship with the customer, retailers might have been expected to be less intensive in seeking to collect delinquent debts than would other types of consumer creditors. Indeed, although many factors explain the displacement of store-branded credit cards by general acceptance bank-issued credit cards in recent decades, one contributor is that bank-issued credit cards allow retailers to avoid the negative effects of alienating customers because of their collection efforts, including, in some cases, repossessing collateral.¹²⁵

In fact, findings by the National Commission on Consumer Finance provided circumstantial evidence that retail creditors tended to be less intensive at collecting delinquent debts than were other creditors. The study found that the grace period before a customer account was declared delinquent was more than three times longer for a retail trade creditor than for a bank lender

¹²³ Zywicki, *supra* note 68, at 146-159.

¹²⁴ *Id.* To offset losses on their credit operations, retailers also would mark up the cost of the goods they sold, especially those such as appliances that were typically sold on credit.

¹²⁵ See Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, in ICLE FINANCIAL REGULATORY PROGRAM WHITE PAPER 12-13 (Institute of Continuing Legal Education, June 2, 2010), http://mercatus.org/sites/default/files/zywicki_interchange.pdf.

(thirty-nine days versus twelve days) and more than twice as long as for a finance company (thirty-nine days versus sixteen days).¹²⁶ Moreover, retail creditors were substantially less likely than banks or finance companies to telephone the debtor's employer or neighbors or to personally visit the debtor (more intensive techniques that were disfavored by debtors) to try to collect the debt.¹²⁷ At the same time, retail creditors were over three times more likely than banks or finance companies to describe referral to a third-party collection agency as an effective method for collecting a debt.¹²⁸ This finding suggests that the ability to outsource debt collection was especially valuable to retail creditors, perhaps because of a reluctance to take more aggressive action on their own.¹²⁹

Economists Viktor Fedasayeu and Robert Hunt have suggested a related way in which third-party debt collectors increase the efficiency of the system.¹³⁰ Recall that one traditional rationale for regulation was the fear of adverse selection: lenders that are lenient regarding collections will tend to attract those borrowers with the

¹²⁶ See *Consumer Credit in the United States*, in 1 TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 43, exhibit 3-2 (Dec. 1972).

¹²⁷ *Id.* at 44, exhibit 3-4. For example, while 56% of banks and 49% of finance companies reported that they would sometimes contact the debtor's employer to collect a debt, only 28% of retail installment creditors reported that they did so.

¹²⁸ *Id.* at 44, exhibit 3-3. Seven percent of banks, 6% of finance companies, and 22% of retailers identified referral to a collector as an effective means for collecting a debt.

¹²⁹ These differences in practice between banks and retailers do not demonstrate that either one pursues the optimal intensity level in collections, but it does illustrate that they are not alike and that they hold different levels of concern about goodwill, which may explain why retailers might place higher value on the use of third-party collectors. In other words, both intensity levels could be efficient in the particular context in which they operate.

¹³⁰ Viktor Fedaseyev & Robert M. Hunt, *The Economics of Debt Collection: Enforcement of Consumer Credit Contracts* (Fed. Reserve Bank of Phila. Working Paper No. 14-7, 2014).

greatest risk of default.¹³¹ Thus, to prevent adverse selection from unraveling their credit pool, lenders will compete to be relatively less lenient than their competitors, potentially creating an arms race toward more intensive debt collection practices that could result in a market equilibrium characterized by inefficient, overly intensive debt collection practices that dampen consumer demand for credit more than they increase lender supply. If so, both lenders and borrowers could benefit from regulations that prevent this inefficient race.

But that particular argument is incomplete once a lender's concern about preserving customer goodwill is considered. In that case, the adverse selection dynamic can theoretically run in the opposite direction, producing a market equilibrium characterized by inefficiently *lenient* debt collection practices. Although it is true that a creditor that adopts more intensive collection practices will reduce losses in the short run, using more intensive collection practices will also alienate consumers, causing the creditor to lose business to lenders that adopt less intensive debt collection practices. Thus, lenders concerned about their relative reputations may be led to be overly lenient in efforts to collect debts, out of fear that they will alienate possible consumers (as is arguably the case for retailers, as previously discussed).

Fedasayeu and Hunt argue that one function of third-party debt collectors is to prevent this race to lenient collection practices by essentially allowing creditors to implicitly coordinate their level of intensiveness in pursuing debtors for collection.¹³² If multiple competing creditors retain the same collection agency, then no single creditor will suffer relative reputational harm from pursuing intensive collection strategies. As the agent for all creditors as a group, the debt collection agency will be unconcerned about the relative reputation among creditors but instead might act more closely to how an individual creditor would act: namely, to maximize the equi-

¹³¹ See *supra* discussion at notes 88-89.

¹³² Fedaseyev & Hunt, *supra* note 129.

librium quantity of credit supplied and demanded. Fedasayeu and Hunt write,

Without third-party debt collectors, creditors would be forced to collect on their own and would tend to use lenient collection practices for fear of damaging their individual reputations (which would reduce demand for their services). A third-party agency collecting on behalf of several creditors, on the other hand, may use harsher debt collection practices than the creditors would. This is because those practices will be associated with all creditors that hired this agency, in which case, borrowers cannot discriminate against individual creditors. As a result, all creditors that hire third-party debt collectors may have bad reputations, but no individual lender may be seen as any worse than any other individual lender.¹³³

The debt collector, as an agent for the industry as a whole, would essentially internalize all of the costs and benefits of the level of debt collection intensiveness that it chooses, including any reputation effects on the industry as a whole. Most significant, however, the debt collection agency would be willing to use more intensive debt collection practices than would individual creditors acting in an uncoordinated fashion. Fedasayeu and Hunt point to the generally accepted belief that collection agencies tend to use more intensive debt collection practices than do creditors. Thus, even though third-party collectors use more intensive tactics than do creditors collecting their own debts, the tactics used by third-parties are not necessarily inefficiently aggressive; it depends on the context whether use of third parties will improve consumer welfare overall.¹³⁴ Fedasayeu and Hunt write:

Since third-party debt collectors facilitate more effective collections than individual creditors are

¹³³ *Id.* at 2.

¹³⁴ *Id.* at 28.

able to implement on their own, their presence can increase the supply of credit and may raise total borrower welfare under certain conditions. At the same time, there are circumstances under which the existence of third-party debt collection agencies may lower borrower welfare because of the increase in the overall harshness (and therefore disutility) of debt collection.¹³⁵

Moreover, riskier borrowers could benefit the most if the increase in post-default recoveries leads to a reduction in interest rates and expansion of supply to riskier borrowers.¹³⁶

The unique value contributed by third-party debt collectors in Fedaseyeu and Hunt's model is the willingness of third parties to use more intensive debt collection measures than creditors would use if they were collecting their own debts. The overall value of the consumer credit system, therefore, is maximized by the combination of two different types of parties seeking to collect debts: creditors collecting their own debts, who will be relatively less intensive in collecting, and third-party debt collectors and debt buyers, who will be relatively more intensive in collecting. Thus, the value of third-party debt collectors stems precisely from their distinctive willingness to use more intensive measures than creditors use collecting their own debts. Precisely because debt collectors are less constrained by goodwill concerns, consumers benefit from their use by lenders in some situations. Indeed, third-party debt buyers and collectors may be the market solution to what otherwise would be market failure and adverse selection problems. In other words, although it is generally recognized that third-party debt collectors tend to use more intensive collection procedures than creditors use collecting their own debts, this observation does not necessarily imply that the methods used by debt collectors are excessively intensive or that the efficient level of effort would be reached by forbidding creditors from outsourcing collec-

¹³⁵ *Id.* at 3.

¹³⁶ *Id.* at 27.

tion. The optimal mix of first-party and third-party debt collection will likely vary across industry and type of debt.

VII. ANALYZING CFPB'S PROPOSED REGULATIONS

From its inception, the CFPB has styled itself as a "data-driven agency" whose regulations are grounded in sound economics and empirical support.¹³⁷ Given the complex nature of the economic tradeoffs involved in regulating consumer credit and the potential for unintended consequences flowing from regulation of debt collection practices, this data-driven approach is especially valuable for assessing the wisdom of new regulations on debt collection. The CFPB should conduct rigorous cost-benefit analysis before proposing new restrictions on debt collection activities.

Before adding new regulations, the CFPB should take care to precisely identify what market failure it believes to exist; whether government regulation is the most effective means of redressing that market failure; and whether, in fact, government regulation can be written and implemented in such a manner that the marginal benefits exceed the marginal costs to consumers. Each of these steps requires careful analysis. For example, as noted previously, although the CFPB has articulated a plausible hypothesis of market failure that arises from the inability of consumers to choose the identity of their debt collector, that argument is incomplete as a theoretical matter and contestable as an empirical matter. In fact, what looks at first glance like a market failure might actually be the *solution* to what otherwise would be a market failure, thus raising the possibility that efforts to protect consumers might actually result in harming them instead.

But even if a market failure is determined to be

¹³⁷ See CFPB, CONSUMER FINANCIAL PROTECTION BUREAU STRATEGIC PLAN FY2013-FY2017 6 (Apr. 2013), <http://www.consumerfinance.gov/strategic-plan/>.

harmful to consumers, the CFPB should also consider whether new government regulation is the most effective way of addressing that market failure. With respect to the debt-buying industry, for example, the industry has established a self-regulatory certification system for debt buyers and, as noted, many large debt sellers have announced that they will sell their debt only to firms that are certified under those standards, in large part because of their concern that the actions of parties to whom they assign or sell their debt will be imputed to them.¹³⁸ Thus, market pressure and voluntary action, combined with oversight from other regulators, might be addressing many of the CFPB's concerns already.

Federal Trade Commissioner Maureen Ohlhausen has provided a general framework for understanding the potential benefits of industry self-regulation as a first line of regulation:

Self-regulation has several advantages over government regulation:

1. It can be more prompt, flexible, responsive, and easier to reconfigure than major regulatory systems that must be changed via legislation or agency rulemaking.
2. Self-regulation will be well attuned to market realities where self-regulatory organizations have obtained the support of member firms.
3. Judgment and hands-on experience enable bright-line rules that are workable for firms.
4. Through compliance generated through "buy-in," it can offer a less adversarial, more efficient dispute resolution mechanism than formal legal procedures.
5. The cost burden falls on industry participants rather than [the] general taxpayer.¹³⁹

¹³⁸ See *supra* discussion accompanying note 117.

¹³⁹ See Maureen K. Ohlhausen, Comm'r, Fed. Trade Comm'n, Remarks before the Direct Selling Education Foundation Self-Regulation and Consumer Protection Panel (Apr. 7, 2015) at 3. In the same speech, Ohlhausen also discusses the limits to industry self-regulation.

Other regulators also regulate debt collection practices. Notably, the OCC requires banks under its supervision to monitor those to whom the bank sells debt for collection. Before imposing new regulations, the CFPB should consider the extent to which industry self-regulation, market forces, and other regulation also protect consumers and the extent to which additional regulation might actually backfire and harm consumers.

Understanding the economic analysis of debt collection and its regulation can guide the CFPB in its analysis of new debt collection rules. The focus here is on three areas in particular: (1) new information provision requirements between creditors and third-party collectors; (2) regulation of permissible contacts with consumers in light of changes in communications technology, such as the advent of cell phone, email, and text messaging technology; and (3) the collection of debts outside of the statute of limitations.¹⁴⁰ The point of this analysis generally is not to definitively recommend or not recommend certain regulatory provisions but to identify the potential unintended consequences of these types of regulations in light of economic principles and to provide guidance to the CFPB in studying the likely effect of regulation, including potential unintended consequences for consumers—both those who are subject to collections and those who are not.

A. Information Provision Requirements

Although the CFPB's basis for requiring creditors to provide collectors with additional information is somewhat murky, apparently the CFPB believes that a market failure can be corrected by increasing incentives to creditors to provide accurate and adequate amounts of information to debt collectors. The ANPR states, "[i]ncentives in the marketplace may not be sufficient in some circumstances to result in collectors having ade-

¹⁴⁰ A fourth area, the CFPB's consideration of applying the rules of the FDCPA to creditors collecting their own debts, has been implicitly discussed already and will not be repeated here.

quate information.”¹⁴¹ For example, the CFPB argues that “debt collectors seeking to maximize profits may not acquire sufficient information about the amount of debts [owed],”¹⁴² because having an accurate assessment of the total amount owed may not benefit the third-party collector sufficiently in light of the cost to the creditor of providing it. Given that increasing the accuracy of information with respect to the balance owed would impose some cost on the creditor, the CFPB asserts that if the cost to the creditor is larger than the benefit to the collector, this information will not be provided. Thus, “[e]ven if collectors would benefit from additional information that permits them to calculate the outstanding balance more accurately, the cost to the collector of acquiring this additional information may still exceed its benefit to the collector, while if the benefits to consumers were considered the overall value of the information may exceed the cost.”¹⁴³

The CFPB’s identification of the precise source and extent of any market failure, however, is not well specified. The CFPB suggests that one justification for requiring the transmission of additional information is that third-party collectors themselves desire more information than is often provided. For example, the bureau claims, “[d]ebt owners, collectors, consumer advocates, and the FTC have all raised concerns about the adequacy of information transferred with debts when debts are placed with a collector or sold to a debt buyer.”¹⁴⁴ Yet the ANPR itself seems to contradict this assertion that third-party collectors lack incentives to insist on adequate information. The CFPB then refers to the findings of a 2009 FTC report, which noted that inadequate information flows in the debt collection system had “repercussions . . . for *both debt collectors* and consumers.”¹⁴⁵ Moreover, a lack of adequate information can be fatal to collection of a creditor’s claim if its enforcement ends up in litiga-

¹⁴¹ Debt Collection (Regulation F), *supra* note 1, at 67854.

¹⁴² *Id.* at 67854, n. 70.

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 67854 (emphasis added).

¹⁴⁵ *Id.* (emphasis added).

tion in order to prove the validity of the claim; hence, third parties in fact do have incentives to seek more information. In addition, the CFPB notes that technological innovation has dramatically reduced the cost to creditors and collectors of obtaining, storing, and transferring data about consumers and their debts, suggesting that it should be easier for debt collectors to obtain the desired information.¹⁴⁶

The combination of these factors—demands by collectors for greater information from creditors combined with declining costs of providing that information—raises doubts about the CFPB's suggestion that creditors have inadequate incentives to provide adequate information to collectors. Although the CFPB may be correct in its belief that there is a market failure and that new mandates for the transmission and storage of information might efficiently address this market failure, it has provided no solid empirical or economic evidence to support those contentions. In particular, CFPB has not tried to quantify the cost of the new requirements to creditors and debt collectors with any rigor, nor has it made an effort to estimate the marginal benefit, if any, to consumers from the new information-sharing requirements.

To the extent that market failure occurs with respect to transmission of information, therefore, the CFPB's real concern appears to be that there are external benefits to consumers from the provision of more information beyond the private benefits to collectors. Before mandating that creditors provide more information to collectors to protect consumers, however, the CFPB should make a rigorous effort to establish how much and what type of information should be provided that currently is not being provided. The CFPB should be careful not to impose needless regulations regarding records preservation and transfer that impose costs without

¹⁴⁶ *Id.* In fact, the CFPB notes that some creditors and collectors have established highly sophisticated information-sharing processes to address these issues. *Id.* at 67855.

compensating benefits. Indeed, in addition to the costs of such regulations to creditors and collectors, requiring greater amounts of information to be transmitted to third parties could raise questions of consumer privacy and security regarding individual information.

The CFPB also should be careful not to create needlessly complicated rules that could permit consumers to escape liability opportunistically. For example, according to the DBA International survey, 80% of debt buyers already believe that more than half the time disputes filed by consumers “are used primarily as a delaying tactic” rather than a good-faith effort to reconcile the unpaid obligation.¹⁴⁷ Although the respondents to that survey obviously are interested (and biased) parties and thus might overstate the number of opportunistic consumers, their thoughts are a reminder that it cannot be assumed that all consumers invariably act in good faith when they dispute a debt. The CFPB should be careful not to create opportunities to escape liability for valid debts on a pure technicality.

As with other regulations that make debt collection more difficult and expensive, there will likely be distributional consequences as well. To the extent that some of the costs of providing information are fixed costs that are invariant to loan size, those regulations will disproportionately increase the cost of collecting smaller debts relative to larger debts. Additionally, although an optimal level of accuracy is to be desired regardless of the size of the debt in question, disproportionately raising the costs of collecting smaller debts could cause creditors to stop providing smaller debt or could force them to raise prices.

B. Communications with Debtors

In its ANPR, the CFPB recognizes that “[p]erhaps the greatest transformations” in the debt collection landscape since the enactment of the FDCPA are “in the tech-

¹⁴⁷ DBA INT’L, INTRODUCTION, *supra* note 49, at 41.

nologies that debt collectors and debt owners use to communicate with consumers.”¹⁴⁸ The problem of crafting an effective regulatory scheme that will keep pace with changes in telecommunications technology is not a new problem. Recall that one of the primary justifications for the FDCPA itself was the dramatic decline in the cost of long-distance phone calls, which enabled out-of-state debt collectors to collect debts more easily and ended the traditionally localized nature of debt collection services. The challenges today are no different, but the experience with the FDCPA is useful to guide regulation in this area. As the CFPB observes:

The statute itself contemplates communications via telephone, postal mail, and telegraph, but it does not reflect the advent of the [I]nternet, smartphones, autodialers, fax machines, and social media. These newer technologies present new challenges and new opportunities. The challenges often arise when attempting to apply the FDCPA’s prohibitions to a technology that was not envisioned at the time of its enactment and may not easily fit its statutory framework. Nonetheless, these technologies also create new opportunities for consumers, debt collectors, and debt owners to communicate in ways that may be more convenient and less costly than prior methods.¹⁴⁹

In addition, many of these new technologies raise regulatory issues that overlap with other regulatory schemes, such as the Telephone Consumer Protection Act, which prohibits using autodialers to call an individual’s cell phone without the individual’s express consent.¹⁵⁰ As originally enacted, the law was meant to protect consumers from telemarketing calls to their cell phones, because cell phone service contracts traditionally required the consumer to pay for any incoming calls to the phone.

¹⁴⁸ Debt Collection (Regulation F), *supra* note 1, at 67863.

¹⁴⁹ *Id.* at 67863.

¹⁵⁰ 47 U.S.C. § 227.

Yet this requirement that creditors must secure express consent before calling a cell phone is much less reasonable today than when first enacted. Many people have *only* a cell phone; thus, if a debt collector cannot use an autodialer to contact a debtor's cell phone it is effectively uneconomical to communicate with debtors by at reasonable cost. According to a 2013 National Health Interview Survey, 41% of American households today have only a cell phone, and an additional 16% have a landline but receive all or almost all calls on a cell phone.¹⁵¹ Thus, over half of American adults use their cell phones exclusively or almost exclusively. Among younger households, the trend is even more pronounced: according to one estimate, two-thirds of households headed by people ages twenty-five to twenty-nine have only mobile phones.¹⁵² Seventy-six percent of people living in rented housing with an unrelated roommate, 61.7% of renters (compared with 28.5% of homeowners), and 56% of those living in poverty (compared with 36% of higher-income adults) also have cell phones only.¹⁵³ Because telephone communications are a low-cost and effective extralegal means for creditors to communicate with debtors, prohibiting contact on the debtor's cell phone will effectively prohibit useful communication between the creditor and debtor. Restricting the ability to contact these households will reduce the likelihood of inexpensive and amicable resolution of disputes and force collectors to use other more expensive techniques, such as lawsuits.

Moreover, it is unclear under current law what

¹⁵¹ Stephen J. Blumberg & Julian V. Luke, *Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, July-December 2013*, U.S. Dept. of Health and Human Services, Ctrs. for Disease Control and Prevention, Nat'l Ctr. for Health Statistics (July 2014),

<http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless201407.pdf>.

¹⁵² Jeffrey Sparshott, *More People Say Goodbye to Landlines*, WALL ST. J., Sept. 6, 2013, at A5.

¹⁵³ *Id.*

constitutes “express consent” by the debtor to permit contact on his or her cell phone. In particular, on an original application for credit, borrowers often provide a cell phone number as their contact number, especially those who have only a cell phone. Does providing a cell phone number on a credit application constitute express consent to be contacted by a debt collector concerning the recovery of the debt? Case law is uncertain on this point.¹⁵⁴ The CFPB should clarify that by providing a cell phone number in connection with a credit application, a borrower is expressly consenting to be contacted at that number in a subsequent collection effort.

Widespread use of cell phones also presents a challenge for the FDCPA’s bar on contacting consumers at “any unusual time or place or at time or place known or which should be known to be inconvenient to the consumer.”¹⁵⁵ Moreover, the statute provides, “[i]n the absence of knowledge to the contrary, a collector shall assume that a convenient time for communicating with a consumer is” between 8:00 a.m. and 9:00 p.m. local time at the consumer’s location.¹⁵⁶

Traditionally, when households relied on landline phones, a collector generally could determine the consumer’s time zone from the area code on the number.¹⁵⁷ Today, however, people take their phones with them when they travel and may travel across time zones. Indeed, consumers frequently take their phones with them when they move permanently. As a result, the phone’s area code is no longer a reliable proxy for the borrower’s location. Given this problem, the FTC recommended that collectors be permitted to assume, for the purpose of determining appropriate calling hours, “that the consumer was located in the same time zone as her home ad-

¹⁵⁴ *Compare* Penn v. NRA Group, LLC, Case No. 1:13-CV-00785-JKB (D. Md. July 1, 2014), *with* Mais v. Gulf Coast Collection Bureau, Inc., 944 F. Supp. 1226 (S.D. Fla. 2013).

¹⁵⁵ 15 U.S.C. § 1692c(a)(1).

¹⁵⁶ *Id.*

¹⁵⁷ Debt Collection (Regulation F), *supra* note 1, at 67864.

dress.”¹⁵⁸ The CFPB should adopt this sensible proposal.

Additional issues arise with respect to communications through email and text messages.¹⁵⁹ Consumers can use caller ID to screen unwanted or inconvenient calls. And although it is true, as the CFPB observes, that many consumers receive alerts when text messages or emails are received, modern mobile phones and the like provide consumers with the ability to silence or use a “do not disturb” function to control notifications at inconvenient hours. Thus, unlike traditional telephone calls, whose ring could disrupt the debtor’s household if received at inconvenient hours, an individual can control the potential for disruption from an incoming text or email message. Moreover, many of the traditional concerns about communications at inconvenient hours can be alleviated by the debtors themselves in this case. In addition, email and text communications are almost always private and read only by the intended recipient.

Despite the benefits of communications through email and text message, a survey of its members by DBA International found that because of the fear of liability resulting from the unsettled nature of law and regulation, only 15% of respondents communicate with consumers through email or other electronic means.¹⁶⁰ In considering the regulation of communications using new technologies, therefore, the CFPB can be informed by the economics of debt collection: prohibiting or limiting the use of low-cost and effective communications technology will lead creditors and collectors to escalate to more intensive collection actions earlier in the debt collection cycle, a development that is unlikely to benefit consumers overall. In fact, many consumer advocates have claimed that the frequency of debt collection litigation against consumers has increased in recent years.¹⁶¹ Although the reasons for this trend have not been studied

¹⁵⁸ *Id.* at 67852 (citing 2009 *FTC Modernization Report* at vi).

¹⁵⁹ *Id.* at 67865.

¹⁶⁰ DBA INT’L, INTRODUCTION, *supra* note 49, at 33.

¹⁶¹ See STIFLER & PARRISH, *supra* note 107.

systematically, a contributing factor could be the decreasing effectiveness of informal communications as a result of changes in communications technology and of heightened regulation. As it has become more difficult to reach consumers by telephone, for example, economic analysis suggests that collectors will more readily escalate to formal, albeit more expensive, techniques for collecting debts, such as lawsuits. Increasing the cost or reducing the effectiveness of debt collection will also lead to a higher minimum-sized debt to be pursued, meaning that many smaller debts will simply be written off without collection, which eventually will filter through the consumer credit system in higher prices and less access to credit for consumers. Given the sweeping changes in the nature of technology and communications with consumers, the CFPB should update the FDCPA and TCPA to permit contact through electronic communications methods, such as cell phones, email, and text.

Enabling creditors to more routinely contact consumers on their cell phones raises novel and challenging new problems, such as contacting consumers when they are away from home, such as at work, in their cars, or at other times when they resent being disturbed. But given the increasing number of households that have no home phone, the costs for consumers of a *de facto* ban on cell phone contacts is high as well, suggesting that regulation that recognizes the need for effectively contacting consumers should be balanced against this risk of intrusion and consumer inconvenience. Striking a balance between the competing goals of facilitating effective communication while protecting consumers from improper disturbance is difficult and eludes easy answers. The CFPB should weigh these concerns carefully.

C. Collection of Debts outside the Statute of Limitations

Another controversial issue regarding debt collection is the collection of time-barred, also called “out-of-statute,” debts—that is, debts that are older than the applicable statute of limitations for bringing a suit to enforce the debt. Federal law currently is silent with respect to the collection of time-barred debts, but some

states limit the use of lawsuits to collect time-barred debts.¹⁶² In 2012, however, the U.S. Department of Justice brought an action on behalf of the FTC against a debt buyer that allegedly collected on time-barred debt without disclosing to consumers that they could not be sued on the debt.¹⁶³ The complaint alleged that it was deceptive for Asset Acceptance not to disclose to consumers that they could not be sued if they did not pay the debt. Later in 2012, the CFPB entered into a settlement agreement with a bank collecting on its own debts that required the bank to provide disclosures regarding its right to sue when collecting debts outside the applicable statute of limitations.¹⁶⁴ Rules also differ among states as to whether partial payment of a debt revives the entire balance due for a new statute of limitations period, although in most states it does. As the CFPB observes, “consumers may believe that when they make a partial payment on a time-barred debt they have only obligated themselves in the amount of the partial payment, but in many circumstances that is not true.”¹⁶⁵

Although collection of out-of-statute debt has received substantial regulatory and other attention, it is not clear whether the issue is a large systemic problem and whether the concern is best addressed through case-by-case enforcement. According to the FTC’s debt-buying report, 87% of the debt purchased by debt buyers from

¹⁶² See APRIL KUEHNHOFF & MARGOT SAUNDERS, *ZOMBIE DEBT: WHAT THE CFPB SHOULD DO ABOUT ATTEMPTS TO COLLECT TIME-BARRED DEBT* (Nat’l Consumer Law Cent., Jan. 2015), https://www.nclc.org/images/pdf/debt_collection/report-zombie-debt-2015.pdf.

¹⁶³ *United States v. Asset Acceptance, LLC*, Case No. 812-cv-182-T027EAJ (M.D. Fla. Jan. 30, 2012), <http://www.ftc.gov/sites/default/files/documents/cases/2012/01/120130assetcmpt.pdf>.

¹⁶⁴ *In re Am. Express Centurion Bank, Salt Lake City, Utah*, FDIC-12-315b, FDIC-12-316k, 2012-CFPB-0002 (Oct. 1, 2012), at 6-7 (Joint Consent Order, Joint Order for Restitution, and Joint Order to Pay Civil Money Penalty), <http://files.consumerfinance.gov/f/2012-CFPB-0002-American-Express-Centurion-Consent-Order.pdf>.

¹⁶⁵ Debt Collection (Regulation F), *supra* note 1, at 67876.

original creditors was less than six years old.¹⁶⁶ Although debt purchased from other debt buyers tended to be older on average, 70% of that debt also was less than six years old.

As with the other specific areas discussed, the CFPB should move cautiously before taking actions that would preempt state law by forbidding collection of time-barred debts or by mandating additional disclosures with respect to time-barred debts. As the CFPB notes, informing consumers that certain old debts are legally unenforceable is likely to reduce their willingness to pay the debt.¹⁶⁷ Additionally, although it may seem unfair at first glance for creditors to collect on debts that are unenforceable, one must remember that higher creditor losses eventually will be passed on to consumers in the form of higher prices and reduced credit access. Moreover, the statute of limitations was never intended merely as a loophole to allow parties to escape liability; rather, it was designed to prevent fraudulent litigation that could clog the court system, to avoid the deterioration of evidence that could undermine the accuracy of the fact-finding process, and to provide defendants with some degree of certainty beyond which they could not be sued.¹⁶⁸ As one law review article described the analytical framework,

From a purely economic point of view, the statute of limitations should bar a claim only when the sum of all costs incurred if the claim is not barred (including the risk of inaccurate adjudication, the costs of record-keeping and insurance premiums, the psychological harm to potential defendants, the disruption of the reliance interests of nonparties, and the like) outweigh the

¹⁶⁶ FTC, STRUCTURE AND PRACTICES, *supra* note 8, at 43.

¹⁶⁷ See Debt Collection (Regulation F), *supra* note 1, at 67875 (citing Timothy E. Goldsmith & Natalie Martin, *Testing Materiality Under the Unfair Practices Acts: What Information Matters When Collecting Time-Barred Debts?*, 64 Consumer Fin. L.Q. Rep. 372 (2010)).

¹⁶⁸ See Tyler T. Ochoa & Andrew J. Wistrich, *The Puzzling Purposes of Statutes of Limitation*, 28 PAC. L.J. 453, 500-509 (1997).

sum of all costs of not implementing the substantive law in what is probably a relatively small subset of cases. If this cost-benefit analysis has been properly calibrated, then the loss of a valid claim is an unfortunate, but necessary, consequence of a trade-off that has been made to maximize social welfare.¹⁶⁹

Notably, many of these potential costs are avoided when a borrower voluntarily pays a debt—even if he is unaware that the debt is otherwise unenforceable under the statute of limitations. More specifically, the statute of limitations is designed to advance goals other than the accurate resolution of litigation on the merits. Thus, preventing the enforcement of time-barred debt disproportionately relieves debtors of the obligation to pay legitimate claims; this result is not within the realm of the policies advanced by the statute of limitations.

Moreover, many of the factors that previously supported limits on the collection of older debt have been reduced in importance in recent years. For example, the risk of inaccurate adjudication and record-keeping costs have been reduced dramatically by technological advances in document retention and provision. In addition, many of these concerns have been ameliorated through government regulation, such as the California Debt Buyers Act, and industry self-regulation, such as the DBA's certification program, that have increased the obligations on debt collectors and debt buyers to retain and transmit accurate information about the collection of older debt.¹⁷⁰

Moreover, although some consumers might benefit

¹⁶⁹ *Id.* at 506.

¹⁷⁰ See DBA, Out-of-Statute Debt: What is a Smart, Balanced and Responsible Approach? 6 (June 19, 2015) (unpublished manuscript) (on file with author). DBA-certified companies, for example, are prohibited from knowingly filing lawsuits to enforce out-of-statute debts. Variation in state laws and complexities regarding choice of law, on the other hand, can lead to the inadvertent filing of lawsuits to enforce debt that could be validly enforced in one state but is time-barred in another.

from laws that forbid the enforcement of time-barred debt, such laws will also have harmful unintended consequences for consumers beyond the obvious economic effect of leading to increased interest rates and a reduction in lending volume, especially for higher-risk consumers. Most notably, by extinguishing debts after the statute of limitations expires, such laws likely increase the number of lawsuits filed against debtors to enforce debts immediately before the expiration of the statute of limitations (although how much more litigation would result is unclear). Using litigation to enforce debts is, of course, an entirely permissible manner of enforcing contractual obligations. Indeed, in some cases, filing suit might actually benefit consumers, either by giving them an opportunity to contest the claim or by bringing the debtor and creditor together to try to negotiate a compromise.

Nevertheless, litigation is expensive and disruptive for consumers, collectors, and the judicial system. When debts are enforced by litigation, the debtor may not only be liable for the debt but also be liable for court costs, interest, and creditors' attorneys' fees. And although litigation theoretically can increase protection for debtors, in practice most debt collection cases result in default judgments. Approximately half or more of debt collection lawsuits result in a default judgment against the debtor.¹⁷¹ Approximately 98% of consumers who are sued regarding debt collection matters do not have legal rep-

¹⁷¹ See Judith Fox, *Do We Have a Debt Collection Crisis? Some Cautionary Tales of Debt Collection in Indiana*, 24 LOY. CONSUMER L. REV. 355, 377 (2012) ("Of the 97,027 cases resolved by the Indiana courts in 2009, 58,979, or roughly 61% were resolved by default judgments for the plaintiffs."). See also STIFLER & PARRISH, *supra* note 107, at 13. Stifler and Parrish also claim that a greater percentage of debt collection lawsuits involving minority and low-income debtors results in default judgments than do lawsuits overall. *Id.* at 18-19. See also Peter A. Holland, *Junk Justice: A Statistical Analysis of 4,400 Lawsuits Filed by Debt Buyers*, 26 LOY. CONSUMER L. REV. 179, 228 (2014) (reviewing studies and estimating that roughly 38-81% of debt collection cases result in default judgments).

resentation.¹⁷² Although the CFPB's ANPR poses several questions regarding regulation of collection of time-barred debt, it asks no questions about whether doing so would increase litigation against consumers or whether consumers would be made better off overall, questions the agency should explore before limiting the collection of time-barred debt.¹⁷³

Extinguishing time-barred debts may have another adverse unintended consequence for some consumers. Even if a debt is legally discharged, it still remains on the consumer's credit report for seven years. Once the debt is legally extinguished, however, the debtor cannot settle it and, as a result, has no means of removing the unpaid debt from the credit report. For debtors who would like to clear old debts to purchase a home, secure a job, or obtain a security clearance, the costs of the inability to settle a time-barred debt can exceed any short-term benefit gained from being released from the legal obligation to pay it.¹⁷⁴

VIII. CONCLUSION

Debt collection is one of the most heavily regulated areas of the consumer credit ecosystem. Yet it is also one of the most important: without an efficacious and efficient debt collection system, creditors will be unable to lend, and borrowers will be unable to borrow. Although consumers who do not pay their debts are benefited by an excessively restrictive debt collection regulatory regime, everyone else pays more in the form of higher interest rates and reduced access to credit. High-risk borrowers, however, will likely feel the effects the most. Moreover, although low-risk and higher-income borrowers who can provide collateral may avoid many of the costs of a less efficient debt collection regime, high-risk and lower-income borrowers will not. High-risk borrowers might instead be driven toward greater use of

¹⁷² See Holland, *supra* note 170, at 187.

¹⁷³ See Debt Collection (Regulation F), *supra* note 1, at 67875-76.

¹⁷⁴ See DBA INT'L, DEBT BUYING, *supra* note 2, at 8.

pawnshops and payday lenders.

Identifying optimal debt collection rules is a challenging economic problem: although more restrictive regulation raises the cost of lending for creditors (thereby reducing the supply and raising some costs), it also can increase the demand for credit by consumers. And although regulators have asserted the presence of a variety of market failures, their magnitude is unclear, and regulators must be very cautious about imposing new regulations whose costs exceed the benefits for consumers. Regulations that provide consumers with "protections" that are not justified by the costs that they impose will not benefit consumers. Especially because of the extensive regulatory regime already on the books, many of the most controversial debt collection practices that are most likely to harm consumers have already been regulated. Against this regulatory backdrop, finding additional restrictions for which the marginal benefits exceed the marginal costs will be challenging.

In addition to understanding the macro effect that debt collection regulations have on the price of and access to credit, regulators should consider the internal economic logic of debt collection. Economists have identified a sliding scale of debt collection practices, starting with the least expensive and least intensive measures, such as phone calls and letters, and then escalating to more intensive and more expensive measures only where less intensive measures fail and more expensive measures are cost justified. Indeed, in some instances of small-dollar accounts, creditors or debt collectors originate no contact at all, waiting for the consumer to contact them. Inefficient limits on debt collection efforts, however, will short-circuit this organic process of escalation. Therefore, if less intensive measures are unavailable or reduced in effectiveness, creditors and collectors will escalate their collection efforts more rapidly (a move that is unlikely to benefit consumers) or, alternatively, will simply write off smaller debts (a practice that is also of dubious benefit because it will lead to less lending to those consumers in the future).

The debt collection dynamic has particular relevance for regulations governing emerging electronic technologies such as cell phones, email, and text messages. Today, those electronic means are the most effective ways to reach many consumers, and the only way to reach a growing number of consumers. Yet current law is written for 1970s and 1980s technology and is focused on landline telephones and letters. Not only are cell phones, email, and the like the most effective way to reach consumers, but also the private nature of these technologies and the consumer's ability to control them (by, for example, turning off ringers, silencing calls, or controlling alerts) alleviates many of the concerns about traditional methods, such as disruptive telephone calls. Although permitting contact of consumers on cell phones and the like raises novel issues of consumer protection, the CFPB should carefully try to balance those concerns against the opportunities that these technologies present for a more effective and less litigious debt collection system.

Finally, in considering new regulations, the CFPB also should consider the larger economic and regulatory context and the way its new regulations will interact with other institutions. First, it should consider how new regulations can complement existing market incentives and self-regulatory structures, taking into account the peculiar characteristics of particular industries, such as the size of the average debts to collect and the tools available to collect on them. Private solutions may provide greater flexibility and higher value at lower cost for consumers and the economy than new government regulations. Second, the CFPB also should consider the ways in which its regulations interact with other regulatory bodies, such as the OCC. Third, the CFPB should consider the way in which one-size-fits-all regulations might interact with state regulations, including state substantive regulations of other terms of consumer credit contracts, such as usury regulations.