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VIEWPOINT

# Use Free Market To Fix Credit

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Among the most controversial features of the financial reform law just passed by Congress is the new Consumer Financial Protection Bureau. Left-wingers want the bureau to promulgate tough regulations that end practices that they consider predatory lending. Right-wingers fear an expensive regulatory straitjacket.

Such knee-jerk responses ought to be tabled in favor of something better for both sides. The new bureau should take a fresh approach to consumer credit, one that relies on market principles. Let credit providers create attractive, useful features for credit cards and mortgages that are profitable for lenders; let consumers opt in if they want them.

That approach would be a lot better than the way federal consumer credit regulation has been handled under the Fed's Regulation Z, which relies on "adequate disclosure" of credit choices to protect consumers. In congressional testimony over the past three years concerning the credit card industry, consumer advocates and industry defenders alike agreed that "disclosure" has failed.

Who hasn't opened a credit card statement stuffed with multiple pages of fine print and thrown out the enclosures without even looking at them? This situation reflects neither credit provider duplicity nor consumer stupidity. Rather, it demonstrates that our regulatory framework lacks techniques to make consumers educated and responsible users of credit.

So how do we replace this ineffective system? In the terminology of Richard Thaler and Cass Sunstein in their book "Nudge," the bureau should be both paternalistic and libertarian. It should be paternalistic in encouraging consumers to understand the features of their credit cards and mortgages and in discouraging unhealthy credit practices. It should be libertarian by permitting consumers, rather than regulators, to make the final choices among credit options. In short, the free market at work.

How do we implement these principles? Consider two examples:

*Make consumer education interactive.* Consumer credit regulation could be reoriented so that consumers and credit providers share an interest in educating consumers about the features of their credit cards or mortgages.

For example, Regulation Z requires that a credit card solicitation include a Schumer Box — a table containing important credit card terms.

But who ever reads it? An alternative — one more likely to ensure consumer understanding — is provided by the credit card industry itself. Before they can be activated, most credit cards require the consumer to call a toll-free number and key in the card number. What if regulators also required, as a condition of card activation, that the consumer pass a multiple-choice telephone quiz based on the Schumer Box (e.g., what is the penalty interest rate?)? The card would be activated only if the consumer correctly answered a minimum number of questions. This system would underscore the importance of understanding the credit terms to both provider and consumer, incentivizing both to ensure the education takes place. Otherwise the card isn't activated, and no one is happy.

*Make expensive terms a la carte.* Lenders could be required to offer "healthy" credit options that consumers would have to choose not to accept, replacing the current system in which the automatic option makes it easier for consumers to get themselves into financial trouble and may be difficult to self-police. For example, credit cards only require a small monthly payment (maybe 5% of the balance). As a result, most cardholders reflexively pay only part of their bill and carry substantial monthly balances, resulting in large interest payments.

Regulators could instead require card issuers to make the full balance (or a high percentage, say 90%) due at the end of the month, with the consumers having the right when they buy the card to opt for a lower minimum monthly payment. Thus, the consumer's automatic — but not mandatory — credit option errs on the side of fiscal prudence. If a consumer wants to carry more debt, he can choose to do so.

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