



Testimony of Professor Todd Zywicki Presented to
The United States Senate Committee on Banking, Housing, and
Urban Affairs
“Examining Mandatory Arbitration in Financial Service Products”
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Chairman Brown, Ranking Member Toomey, and Members of the Committee:

I am Todd Zywicki. I am George Mason University Foundation Professor at Antonin Scalia Law School and Research Fellow of the Law & Economics Center. I am also co-author of *Consumer Credit and the American Economy* (Oxford 201465). From 2020-2021 I served as the Chair of the CFPB's Taskforce on Consumer Financial Law and from 2003-2004 I served as the Director of the Office of Policy Planning at the Federal Trade Commission. It is my pleasure to testify today on the question of "Examining Mandatory Arbitration in Financial Service Products." I appear voluntarily today in my personal capacity and do not speak on behalf or represent any other party.

In 2015 the Consumer Financial Protection Bureau published a Study on the use and effect of arbitration clauses in consumer financial services contracts. See Consumer Financial Protection Bureau, *Arbitration Study: Report to Congress, pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act §1028(a)* (March 2015) (hereinafter the "Arbitration Study"). The findings of that study led the CFPB to issue a rulemaking that barred consumers and providers of financial services from entering into contractual agreements to arbitrate any disputes that later arose pursuant to the contract. In turn, that rule was later rescinded by Congress acting under the authority of the Congressional Review Act.¹ My testimony today is based primarily on a law review article that I co-authored with Professor Jason Johnston that critiques the findings and methodology of the CFPB's Arbitration Study, *The CFPB's Arbitration Study: A Summary and Critique* (with Jason Scott Johnston), 35(5) BANKING AND FINANCIAL SERVICES POLICY REPORT 9 (May 2016), attached hereto.

Although many consumer financial products are complicated and consumers can get confused, consumer financial services markets are largely competitive and regulation such as the Truth in Lending Act operates to try to make the terms of consumer financial services products transparent and understandable to consumers.² According to Federal Reserve data, consumers are on generally with the products and providers they choose and they report that if they feel mistreated or dissatisfied by their treatment by a provider they can switch to an alternative provider at low cost.³ Innovations such as credit scoring and the development of Internet comparison websites have made it even easier for consumers to find the financial products that work best for their family. This robust choice, competition, and ability to switch to alternative providers empowers consumers and largely explains their generally high level of satisfaction with their chosen bank or credit card issuer.

Yet not all goes smoothly all the time in this or any other market. Deception, fraud, and other mistreatment sometimes occurs as in any market. On the other hand, sometimes a consumer subjectively feels wronged but no illegal or other improper action has been taken. This problem of potential harm from improper treatment raises the question of the best way to resolve the occasional disputes that arise between financial

¹ CODE OF FEDERAL REGULATIONS, ARBITRATION AGREEMENTS, 82 Fed. Reg., No. 224 (Nov. 22, 2017).

² BUREAU OF CONSUMER FINANCIAL PROTECTION, 1 TASKFORCE ON FEDERAL CONSUMER FINANCIAL LAW REPORT, Chapters 8 and 9 (Jan. 2021).

³ See DURKIN, ET AL., CONSUMER CREDIT AND THE AMERICAN ECONOMY 308-316 (2014).

service providers and their customers in an expeditious and efficient manner while at the same time minimizing the impact and cost of these disputes on the overwhelming number of interactions that do not result in conflict. Expensive or cumbersome processes to resolve disputes, as well as large and unpredictable levels of liability to providers, can result in substantial uncertainty and liability risk that issuers will pass on to other consumers.

In a large number of instances today, consumers and providers voluntarily agree to contractual terms that provide that any dispute that arises under the contract will be resolved by arbitration. The subject of today's hearing focuses on whether those pre-dispute agreements to arbitrate any disputes that arise should be enforceable and whether Congress should consider legislation to prohibit such terms.

Based on the longstanding encouragement provided by federal law in support of arbitration, my prior research on the issue, and the importance of contractual choice in the economy, and, I believe that such legislation would be unwise at the current time. Moreover, before any legislation is considered, the CFPB should update and redo its prior flawed study on arbitration in a more competent, transparent, and accountable form to better understand the impact of contractual provisions requiring arbitration of any disputes.

It is my opinion that based on the current state of knowledge it would not be useful for consumers for Congress enact new legislation that prohibits consumers and financial service providers to agree to resolve disputes that arise under their contracts by arbitration.

Congress has consistently articulated a long-standing public policy favoring resolution of disputes by arbitration and other private alternatives to litigation. Congress's commitment to that principle was reaffirmed by the Supreme Court as recently as a decade in the case of *AT&T v. Concepcion*, which involved a binding arbitration provision in a cell phone contract. Litigation is expensive for both the parties and the public and arbitration and other alternative dispute resolution procedures have been recognized for decades as providing a mechanism for resolving disputes inexpensively and expeditiously.

Moreover, although contractual provisions to arbitrate disputes are initially agreed to by contract, the terms of arbitration processes a substantial body of common law regulation has been built up by courts to ensure that they are fair and effective alternatives to lawsuits, including ensuring the location is convenient, processes are not unduly expensive, and in many cases, consumers who prevail in arbitration can recover some minimum amount of damages that exceeds their actual out-of-pocket harm. The rapid adoption of virtual arbitration proceedings using video conferencing has further reduced the cost and increased the accessibility of arbitration.

Arbitration processes are designed so that consumers need not retain a lawyer to vindicate their rights, unlike court proceedings that provide a maze of possible land mines for *pro se* plaintiffs. The Arbitration Study found that many arbitration claimants retain

lawyers to represent them. The Arbitration Study also found that self-represented consumers fare almost as well as those represented by an attorney and most consumer arbitration claimants obtain either settlements or arbitral awards.

Available evidence suggests that the presence of arbitration clauses in consumer finance contracts is consistent with the operation of a competitive market with consumer choice. Although critics claim that consumer finance contracts with arbitration clauses are offered on a “take it or leave it” basis to consumers and that as a result consumers lack meaningful choice to deal with providers whose contracts do not require binding arbitration clauses. But according to the Arbitration Study only 8 percent of banks and 16 percent of credit card contracts contained arbitration clauses during the timeframe examined. I have not located a comprehensive recent analysis, but news reports suggest that consumers who are concerned about preserving their rights to sue can easily find a card that will provide them that option, even among larger card issuers.⁴ Moreover, many issuers that do have contracts that contain arbitration clauses also provide a process for consumers to opt-out of that provision by notifying the issuer. Some also permit consumers to bring individual claims in small claims court, notwithstanding the presence of an arbitration clause. As a result, it appears that consumers who desired a credit card or bank account with no arbitration clause would have little problem finding one. Moreover, the explosion of Internet banks and credit card issuers has further increased competition and consumer choice for those who seek contracts that do not contain such a provision.

Many consumers do not know expressly whether their financial contracts contain an arbitration clause. But this is hardly surprising and does not suggest the presence of a market failure. First, the overwhelming number of interactions between consumers and financial service providers are productive and positive. Second, as noted, judges have developed extensive common law rules governing arbitration to ensure that arbitral processes are fair and effective at vindicating consumers’ rights if disputes do arise. Third, and most important, consumers recognize that given the competitive landscape of consumer financial markets, they have multiple tools at their disposal to protect themselves and see litigation and arbitration as last resorts. In most instances, consumers who feel mistreated by a provider simply complain or threaten to change providers, often resolving their dispute.

The Arbitration Study confirms what the rest of already know from personal experience—if we are dissatisfied with the service we receive from any company (whether a bank, department store, airline, or anyone else) we do not immediately contact a lawyer and threaten to sue. Instead, we contact the provider and seek a refund of the disputed charges. We may even threaten to cancel our account and post a negative review on social media. Businesses will often respond.

Survey evidence collected by the CFPB as part of its research confirmed this finding. When asked what they would do if they felt they had been mistreated, the

⁴ See Fred O. Williams and Caitlin Mims, *Mandatory Arbitration: Most Credit Cards Allow a Way Out* (Aug. 20, 2019), available in <https://www.creditcards.com/statistics/avoid-arbitration-study/> (reporting that at that time several large credit card issuers did not have arbitration clauses in their contracts).

overwhelming majority of consumers reported they would request a refund from their provider and if they remained dissatisfied they would switch to another financial institution. The CFPB found overall that when asked what they would do if they were assessed what they believed to be an incorrect fee, 57 percent of consumers said they would cancel their credit card while only 1 percent would even think about pursuing a lawsuit.

As part of our research, Professor Johnston and I obtained reports from one mid-size regional bank with respect to their internal dispute resolution processes on a variety of charges such as overdraft fees, to ATM fees, and others. We found that 2/3 of all customer complaints were resolved with a complete refund to the consumer. Moreover, the average refund amount in response to customer complaints was \$55.09, compared to an average recovery of \$32 for consumer class actions in the cases where consumers actually recovered anything. Overall, the bank voluntarily provided \$2.275 million in customer refunds during the one year we examined. It is very expensive for banks to acquire new customers and few successful companies are so short-sighted as to be willing to alienate a longstanding customer simply to collect on a couple of overdraft fees or a late fee.

Recognizing the willingness of banks to provide refunds to consumers who complain undermines the central conclusion of the Arbitration Study, which is that arbitration fails to provide a reasonable and effective means to resolve consumer disputes involving consumer financial services products. The CFPB's rulemaking rested on the finding in the Arbitration Study that there were a relatively small number of small-dollar arbitrations (less than \$1000) in their data set. From this factual finding, the CFPB simply assumed that the explanation for this finding was that arbitration proceedings are cost-prohibitive relative to the amounts at stake and therefore arbitration does not provide an efficient and effective mechanism for resolving consumer disputes. This finding was the basis of the Bureau's decision to prohibit consumers from choosing to enter into contracts to arbitrate any unresolved disagreements that arose under the contract.

That hypothesis, however, was simply asserted and not demonstrated. An alternative and likely more plausible explanation is that many small dollar complaints—especially meritorious complaints—are resolved consensually, thus there is no need to pursue arbitration or litigation. Moreover, it seems plausible that the majority of those complaints that are rejected are relatively less meritorious. At the very least, before the CFPB or Congress jumps to the conclusion that arbitration proceedings are ineffective or excessively expensive, it should consider alternative explanations.

In the cloud cuckoo land of the CFPB, however, the only way that banks could establish that arbitration provides a suitable means for consumers to seek redress would be to reject consumers' requests for refunds—especially the most valid ones—and force them to initiate an arbitration proceeding. This is absurd. But it illustrates the fallacious reasoning of the reasoning in the Arbitration Study that the absence of many small dollar arbitrations implies that arbitration is ineffective and unduly expensive.

In addition, small dollar arbitration is quite common in other consumer retail industries, such as cell phone contracts. This suggests that whatever the reason for the small number of small dollar arbitration actions in consumer banking services, it is not likely because of a lack of ready and affordable access to arbitrations. Casting further doubt on the CFPB's conclusions about efficiency of arbitration is that over 70 percent of all consumer arbitrations are brought under statutes that permit consumers to claim up to \$1500 in statutory damages per violation without proof of harm. Thus, while the consumer may have suffered relatively small amounts of actual harm they may nevertheless be able to make a credible claim for statutory damages that exceed the \$1000 threshold. Thus, the fact that most arbitration proceedings *request* more than \$1000 may reflect the fact that even if the alleged out of pocket harm to the consumer is small, the amount they are later awarded will often exceed the \$1000 threshold used by the CFPB in its Report.

Moreover, many agreements to arbitrate provide for a minimum recovery if the consumer prevails, which would also lead to a consistent pattern of awards that exceed the CFPB's \$1000 threshold. For example, the arbitration provision in question in *AT&T v. Concepcion* provided for a minimum recover of \$10,000 and twice the amount of the claimant's attorney's fees if the customer receives an arbitration award greater than the company's last written settlement offer. The Arbitration Study found that similar minimum recovery provisions were present in many consumer financial services contracts as well, often in the range of a minimum award of \$5000-\$10,000.⁵

Litigation, by contrast, is a poor mechanism for resolving consumer harms. It is well-established that individual litigation, especially in matters such as debt-collection disputes, is disastrous for consumers. An overwhelming percentage of lawsuits between financial services providers and consumers result in default judgments against consumers. Consumers are not inherently better off by being pushed out of arbitration and into court and in most instances will be much worse off.

Class action lawsuits are not much better in the overwhelming number of cases. As is the case with many consumer class action proceedings in other industries, consumer class actions against banks and other financial services providers typically result in minimal compensation to consumers (often vouchers or coupons) and large payouts to lawyers. Even where class action cases purport to provide recoveries to consumers, the claims rate is exceedingly low.⁶ During the 2010-12 period studied by the CFPB in its Report, class action attorneys raked in a whopping \$424,495,451. In some instances lawyers receive seven figure attorneys' fees payouts even where consumers actually suffer no verifiable harm. These nuisance and "no harm" lawsuits provide no tangible

⁵ See Tony Lathrop, *Could Guaranteeing a Minimum Recovery for Consumers Abate CFPB Concerns Regarding Class Waivers in Arbitration Agreements*, MOORE AND VANALLEN LITIGATION BLOG (Mar. 27, 2015), available in <https://www.jdsupra.com/legalnews/could-guaranteeing-a-minimum-recovery-fo-85786/>.

⁶ The Arbitration Study calculated an unweighted average settlement claims rate of 21% and a median claims weight of 8%. This difference between the average and median claims rate reflects the reality that in the vast majority of cases the compensation offered to claimants from a class action settlement is so trivial that its not even worth the effort to fill out the form and make the claim.

benefits to consumers but drive up the cost of doing business, cost that eventually will be passed on to consumers.

Recognizing this reality, some enthusiastic supporters of class actions will admit that class actions provide a poor vehicle for compensating consumers harmed by improper practices. But they often contend, as former CFPB Director Richard Cordray did, that even if class action recoveries for consumers are often trivial, those filings vindicate the “core American principle” of giving consumers their “day in court.” But this claim too is belied by available evidence as not a single class action case went to trial during the period studied by the CFPB and fewer than 2 percent of cases ended in either a class or individual judgment. Most cases are resolved at the class certification stage with either a settlement or dismissal.

Finally, critics of arbitration argue that even if class actions provide minimal compensation to consumers (and large payouts to lawyers) class actions play an important deterrence role. But this argument is misguided as well. Cases where a large number of consumers suffer harms that are too small in amount to be worth pursuing individual are precisely the reason why we have public enforcement agencies, such as the federal CFPB and FTC, state Attorneys General, and supervisory authorities at the state and federal level. In many cases, public enforcement authorities initially uncover wrongdoing and class action lawyers pile on later. Thus, there is little evidence that class action lawyers provide any meaningful role in deterring wrongdoing beyond that provided by public enforcement authorities. This deterrence argument is particularly weak in the context of consumer financial services in that, as noted, many statutes contain statutory damages provisions which are designed specifically to provide adequate incentives for consumers to sue. Thus, the combination of statutory damages with the threat of class action liability is in many ways produces duplicative recovery (and may explain why class action lawyers are so eager to be able to bring class action claims against large financial institutions).

Based on current data and knowledge, therefore, there does not seem to be persuasive case for restricting the free choice of adult consumers to enter into contracts with financial service providers to agree to resolve any disputes that arise through arbitration rather than pursuing litigation. Given the longstanding and strong presumption embedded in federal law of encouraging alternative dispute resolution, overriding the right of adults to choose to enter into these contracts requires overcoming an exceedingly high burden of proof. The small number of consumers who desire the right to sue if something goes wrong would appear to have little problem finding a provider that will offer that provision. Moreover, common law has developed a variety of mechanisms designed to ensure that arbitration provides fair and efficient processes for resolving disputes. The growing use of video technology to resolve arbitration claims has further reduced the cost and inconvenience of engaging in arbitration.

Thank you for your time and the opportunity to appear before you today and I am happy to take any questions you may have.