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"EXAMINING THE CFPB'S PROPOSED RULEMAKING ON ARBITRATION: IS IT IN THE PUBLIC INTEREST AND FOR THE PROTECTION OF CONSUMERS?"

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Thank you for giving me the opportunity to testify before you today on the CFPB's May 5, 2016 Proposed Rulemaking on Arbitration.

I am the Henry L. and Grace Doherty Charitable Foundation Professor of Law at the University of Virginia Law School. One of my core areas of research activity and expertise is the regulation of consumer financial products and in particular the analysis of alternative methods of consumer dispute resolution. In this work, I utilize my training as both a lawyer and as an economist (obtaining both my J.D. and PhD in economics from the University of Michigan). As a consultant to the Mercatus Institution of George Mason University, in September, 2015, I produced (along with my co-author, Todd Zywicki of George Mason) a publicly available Research Report entitled "The Consumer Financial Protection Bureau's Arbitration Study: A Summary and Critique." Our paper is cited and discussed by the CFPB in its proposed rulemaking, and my testimony today at some points draws directly upon our "Summary and Critique" Report. I have even more recently posted online the first of several forthcoming papers analyzing data on all consumer class actions filed in the Northern District of Illinois over the period 2010-2012. The first paper, a draft entitled "High Cost, Little Compensation, No Harm to Deter: New Evidence on Class Actions under Federal Consumer Protection Statutes" is available online at http://ssrn.com/abstract=2777618. In my testimony, I refer in a few places to data on consumer class actions under federal consumer protection statutes that is discussed in that paper.

The CFPB proposes to "prohibit companies from putting mandatory arbitration clauses in new contracts that prevent class action lawsuits." According to the CFPB, "the proposal would open up the legal system to consumers so they could file a class action or join a class action when someone else files it. Under the proposal, companies would still be able to include arbitration clauses in their contracts. However, for contracts subject to the proposal, the clauses would have to say explicitly that they cannot be used to prohibit consumers from being part of a class action in court."

The CFPB justified this proposal by the findings in its March, 2015 Arbitration Study. According to the CFPB, its "study found that class actions provide a more effective means for consumers to challenge problematic practices by these companies. According to the study, class actions succeed in bringing hundreds of millions of dollars in relief to millions of consumers each year and cause companies to alter their legally questionable conduct. The study showed that at least 160 million class members were eligible for relief over the five-year period studied. Those settlements totaled $2.7 billion in cash, in-kind relief, and attorney's fees and expenses. In addition, these figures do not include the potential value to consumers of class action settlements requiring companies to change their behavior. However, where mandatory arbitration clauses are in place, companies are able to use those clauses to block class actions."

The CFPB set out two benefits from its proposed ban on mandatory arbitration clauses that prohibit class actions. First, it said that "With class action lawsuits, consumers have opportunities to obtain relief from the legal system that, in practice, they otherwise would not receive." Second, the rule would have a deterrent effect by "incentivizing companies to comply with the law to avoid group lawsuits." A third benefit discussed by the CFPB accrues not from the ban but from a separate aspect of the proposal that would require companies that use arbitration clauses to submit any claims filed and awards issued in arbitration to the CFPB. The Bureau would also collect correspondence from arbitration administrators regarding a company's non-payment of arbitration fees and its failure to adhere to the arbitration forum's standards of conduct. According to the CFPB, "the collection of these materials would enable the CFPB to better understand and monitor arbitration. It would also provide insight into whether companies are abusing arbitration or whether the process itself is fair."

In this testimony, I will explain how that rather than demonstrating the benefits of the recently proposed ban, the CFPB's 2015 Arbitration Study strongly suggests that consumer arbitration before the American Arbitration Association (AAA) is a fast, fair, low cost and highly effective means of awarding relief to consumers. Moreover, while the CFPB's study showed that in aggregate, millions of class action members received over a billion dollars in compensation under class settlements, that aggregate class payout cannot be compared with the arbitration outcomes top which the CFPB had access. Moreover, the CFPB's own study showed that in typical class action settlements, a very small fraction of the class receives any compensation at all. As supplemented by my own ongoing work with data on all consumer class actions filed in a representative federal district court (the Northern District of Illinois) over the 2010-2012 period, the accumulating evidence is that aside from a few highly unusual gigantic class action settlements, in the typical class action settlement, a small fraction of consumers are compensated, attorney fees often dwarf the total amount paid to the class, and there is either no evidence of any real deterrent effect or – for the most common class action in both my dataset and the CFPB's, one arising under a federal consumer protection statute – the settling plaintiff did not even allege harm.

It must be stressed that no general conclusions about the effectiveness of arbitration versus class actions can yet be reached by anybody. We simply need more empirical evidence about both arbitration and class action outcomes. The CFPB's 2015 Arbitration Study gathered lots of evidence, but it failed to even gather data on what may well be the most important empirical question for policy design purposes: whether arbitration is a more accurate method of compensation than class action settlements, where accuracy means awarding compensation when and only when the consumer has a valid complaint under statute or common law.

1. Why Accuracy in Dispute Resolution is Crucial to Both Fairness and Efficiency

The accuracy of a dispute resolution system determines both its fairness and its deterrent value. In an ideal system, a consumer recovers damages if and only if a financial defendant has violated a statutory or common law duty to the consumer. If a company ends up making payments even when it has done nothing wrong, then not only do those payments unfairly take money away that could go to the company's shareholders, customers and employees, the payments may also create perverse incentives that harm consumers. After all, if frivolous or spiteful consumer complaints – those where the financial services provider has done no wrong -- end up generating liability anyway, then while a firm still has an incentive to identify and respond to valid consumer complaints – to keep the business of such customers – denying groundless complaints generates costs that may far exceed the value of the business of such complaining customers.

Basic economic theory predicts that firms would try to identify and deny services to consumers likely to raise such bad faith complaints. If firms are unable to accurately identify such customers ex ante, then a system that forces firms to make payments even when they have done no wrong imposes a tax on firms simply for doing business. The bigger the firm – the larger the number of its customers and the number of transactions it engages in – the bigger is this de facto tax. But like every tax, some one has to pay it.

No system of liability and compensation is perfect. Even the best system will sometimes transfer money from firms to consumers when the firm has done nothing wrong, and conversely sometimes fail to order such a transfer when the firm has indeed violated a statutory or common law duty owed to the consumer. The most important public policy question regarding the choice between arbitration and class actions is how well and at what cost each system performs in minimizing the social costs of these two types of errors.

2. Perhaps the Main Finding in the CFPB's Study is that through Market Choices, Consumers Themselves Incentivize Firms to Respond Quickly and Fairly to Valid Consumer Complaints

The CFPB's 2015 Study reports the results of a survey in which the CFPB asked consumers what they would do if they complained to a credit card company about a charge that the company had incorrectly assessed on their bill. Fewer than 2 percent of the respondents said that they would seek legal advice or consider failing a lawsuit. But almost 60 percent of those surveyed said that they would cancel their account with that credit card company and take their business elsewhere.

Companies clearly seem to take this threat seriously. Evidence discussed by Todd Zywicki and I in our recent critique of the CFPB's 2015 Study is that at least one medium sized bank in Texas grants refunds between about 60 and 90 percent of the time when consumers complain about fees for things such as wire transfers and inactive accounts. Clearly there is a big market sanction for firms that do not invest adequately to resolve consumer complaints in a fair and speedy way, and the vast majority of consumers say they punish firm who fail to make such investments and end up denying valid complaints.

It should be noted that in its rulemaking, the CFPB opines that the variation in refund rates across bank branch offices in the data reported by Johnston and Zywicki likely reflects the practice by companies of giving refunds to profitable consumers but not to those who are unprofitable. While we do not know what explains variation in refund rates across branch offices, the simplest explanation is that it likely reflects variation in the rate at which consumers raise valid complaints about fees. And of course inasmuch as consumers who raise groundless complaints are not the ones that firms want to keep, granting relief only to valid complaints is fully consistent with the goal of furthering profitability. The CFPB holds to a worldview in which fairness to consumers is inconsistent with firm profitability. Especially in the world of lightning fast mass consumer communication over the internet where millions of consumers share their perception of whether a financial firm is fair, it seems much more likely that fairness to consumers supports firm profitability.

3) Because the CFPB's Report Shows that AAA Arbitration can be an Effective Means of Resolving Consumer Disputes and that Arbitration can Enhance Firm Incentives to Fairly Resolve Consumer Complaints, an Outright Ban on Arbitration Clauses Precluding Class Action Relief is not Warranted

Given this market incentive for firms to treat consumers fairly, the question is how class actions and arbitration compare as mechanisms for complementing market incentives. That is, the relevant policy question is how arbitration and class actions compare as devices for getting compensation to consumers who have suffered a real wrong at the hands of financial services providers, but wrongs that the market does adequately incentivize providers to correct, so that firms must be made to pay when they otherwise would not.

One kind of comparison between class actions and arbitration, invited by the CFPB's 2015 Study, is to compare class action settlements with actual claim awards in arbitration. The CFPB's 2015 Report reported a widely publicized number which the recent rulemaking repeats: that from class action settlements, over the 2008-2012 period, over 11 million consumers received over $1.1 billion in compensation. By comparison, the CFPB found that over the 2011-2012 period, only 32 consumers succeeded in getting awards in AAA arbitration – comparable to a damage award in litigation -- and that those awards totaled $172,433. Putting the obvious bias in comparing totals from class action settlements over a five-year period with arbitral awards for two years, the entire comparison is invalid. One cannot compare arbitral awards to class action settlements. This is an apples to oranges comparison that is highly misleading and can only lead to bad public policy. One can properly compare class action damage awards to arbitration damage awards, or class action settlement amounts to arbitration settlement amounts, but not settlements to damage awards.

The CFPB could not draw the proper comparison – between class action settlements and arbitration settlements – because the AAA apparently refused to give the CFPB access to arbitration settlement amounts. Before rushing to condemn the AAA for its lack of transparency, one must recognize that all AAA settlements are in individual consumer arbitrations. Likewise, the terms of individual litigation settlements in state and federal trial courts are not publicly available.

What the AAA did reveal to the CFPB about individual arbitrations, however, shows that arbitration likely generated payments to consumers most of the time, with the CFPB classifying a full 57% of all consumer arbitration filings as either known to or likely to have settled. With another 6 percent of consumers getting an award from the arbitrator, while the CFPB did not know the amount of these settlements, it did learn that 63 percent of the time, consumers receive some payment after filing a claim before the AAA. In arbitrations where consumers did receive awards, the average award was $5389, a substantial amount that clearly would justify filing the lawsuit.

The CFPB also found that arbitration is so cheap and procedurally simple and yet fair that consumers do not need to pay a lawyer to get such payouts. Firms that use AAA for arbitration must abide by the AAA's "Consumer Due Process Protocol." This ensures the fairness of AAA arbitration, among other ways by guaranteeing arbitrator neutrality and by requiring that the arbitration take place within a reasonable distance of the consumer's home (indeed, the CFPB found that the median consumer traveled only 15 miles to the AAA arbitration, with an average distance traveled of 30 miles). AAA arbitrations are cheap, with the consumer paying only a $200 filing fee, and informal, with claims under $10,000 resolved by default based only on the documents submitted or at most a telephone hearing. As a consequence, even when telephone hearings are held – the most procedurally complex of all AAA arbitrations -- consumers get relief in less than 5 months. Because AAA arbitration is so cheap and informal, even though the CFPB found that most (63 percent) of consumers had counsel, it also found that those without counsel do just about as well in terms of arbitration outcomes as consumers with counsel. The CFPB found that while AAA consumer claimants with counsel got settlements at slightly higher rates (40 percent versus 34 percent), consumers without counsel did much better in actually winning cases decided by an arbitrator, with a win rate of 14 percent being a full seven times higher than the 2 percent win rate of consumers with counsel.

With all these positive findings about the potential benefits of arbitration, why did the CFPB conclude that consumers cannot be contractually bound to arbitrate rather than possibly become a member of a future class action? The answer seems to come in two parts: First, that truly small dollar consumer claims are not feasible in arbitration, and second, that such claims can and often are effectively redressed by class action lawsuits. It is true that the CFPB's 2015 Study found only 23 consumer claims or about 2 percent of all claims sought less than $1000 (the threshold used by the CFPB to define a small dollar claim). As pointed out by Johnston and Zywicki, the fraction of such small dollar claims in the CFPB's arbitration dataset is (statistically) significantly smaller than the 3.5% rate at which such claims appear in publicly available AAA data for the entire

2009-2014 period. This suggests that the financial products arbitrations studied by the CFPB may be different than AAA arbitrations generally.

One way that they may be different is that according to the CFPB's own study, about 33 per cent of all the arbitrations it studied were brought under federal consumer protection statutes that award statutory damages without proof of harm.[1] Under such statutes, such as the Fair Credit Reporting Act, consumers get between $500 and $1500 per violation alleged (or per consumer). As consumers typically seek maximum statutory damages (there is no reason not to do so), claims under these statutes almost always allege at least $1000 in damage and so would not be classified as "small dollar" by the CFPB.

It is true that this leaves two-thirds of the arbitrations studied by the CFPB which are made under state statute or common law. However, the state statute most commonly invoked in the arbitrations studied by the CFPB was a state consumer protection statute, and a strong majority of such state statutes award not just compensatory damages but also statutory and even punitive treble damages. Of the 723 arbitrations studied by the CFPB that did not make claims under a federal statute, fully 372 (or 51 percent) arose under such statutes. Claims under these statutes would not be classified as "small dollar" simply because the statute authorizes statutory and treble damages far exceeding the small dollar $1000 threshold. If we add up all the arbitrations studied by the CFPB arising under federal or state consumer protection statutes that award statutory and/or treble and punitive damages, we get 707, or about 70 percent of all arbitrations studied that could not possibly be classified as small dollar simply because they raised statutory claims. If we compare 23 small dollar claims to the remaining 382 claims remaining that could even possibly be small dollar, we find that small dollar claims are a healthy 6 percent of the total.

It has been argued that even though AAA consumer arbitration is cheap, speedy and informal, with a $200 filing fee it is still too costly for it to be rational for a consumer to pursue a really small claim, one less than $200. This forgets that arbitration is contractual. By contract, firms can and have committed themselves to make fair offers to resolve internally such small claims or else risk much greater liability if a consumer claim is rejected and the consumer pursues arbitration. AT&T Mobility, for example guarantees claimants a minimum of $10,000 and twice their attorney fees if they obtain an arbitration award that is greater than AT&T's last settlement offer. This provision effectively commits AT&T to make fair offers to preclude consumers from going to arbitration at all: that is, by making arbitration a potentially lucrative option for even a small claim consumer, the primary effect of the clause is to *incentivize fair offers by AT&T when the consumer first complains.*

Arbitration clauses such as this are still relatively new, and it is true that most firms do not have such clauses. However, rather than banning arbitration clauses, the CFPB could promulgate guidelines under which clauses such as AT&T's are given regulatory approval as presumptively fair and non-deceptive. In other words, the CFPB

[1] See CFPB Arbitration Study, Section 5, p. 47 (March, 2015).

should create incentives for pro-consumer market-driven contract terms, rather than eliminating the market as a mechanism.

4. Class Action Settlements are a Costly Alternative to Arbitration that often Fail to Compensate Consumers and Transfer Money from Defendant Firms in Cases Where there is no Wrongdoing to Deter

Having clarified that compared with the proper sample of non-statutory claims, small dollar claims in arbitration may be more significant than the CFPB Study suggested, it remains possible that small dollar claims are much more often to be seen in consumer class actions, and when seen in such actions, resolved in a way that generates significant compensation for consumers deterring firms from future wrongdoing.

First it must be noted that the vast majority of claims in consumer class actions in federal court arise under the same statutory damage – conferring federal consumer protection statutes found in the CFPB's arbitration sample. According to the CFPB, class action complaints raising claims under these same federal consumer protection statutes made up about 72 per cent of all cases filed in federal district courts nationwide over the period 2010-2012. In my own sample of all consumer class actions filed in the Northern District of Illinois over the same period, cases arising under federal consumer protection statutes made up about 76 percent of all filings. Thus the vast majority of federal class action filings do not, by definition, involve small dollar claims.

In my study of consumer class actions filed in the Northern District of Illinois under federal consumer protection statutes, I found that over half were suits seeking statutory damages without even an allegation, let alone proof of harm to consumers. Thus such class actions are not only not small harm suits, they are actually no harm lawsuits. With no harm even alleged, class action settlements in such suits cannot be argued to serve either to deter firms from harm causing behavior or to compensate consumers for harm they have suffered.

Still, it must granted that the 419 class action settlements reached between the years 2008 and 2012[2] that the CFPB studied included all types of filings, both those under federal and state consumer protection statutes awarding statutory damages and those under other statutes or state common law. Of these, the CFPB found 251 in which it was able to gather data on the amount paid to the class, but only 105 in which it was able to describe fully the key outcomes of a class action settlement: the amount actually paid to consumers in total, the amount of attorney fees, and the fraction of the consumer class that actually received any payment.[3] The CFPB reported that on (unweighted) average, 21 per cent of the class received compensation, and that attorney fees also averaged 21 percent of the total relief granted to the class.

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[2] The CFPB apparently gathered class action settlement data over a long period of time than for either its arbitration or litigation filing datasets.
[3] CFPB Arbitration Study at Section 8, p. 30.

The CFPB's finding on the fraction of class members actually receiving compensation is somewhat higher than previous research has found, but it is not far out of line with my own ongoing research. My own investigation of class settlements under federal consumer protection statutes (in cases filed in the Northern District of Illinois over the period 201-2012) has found that claims rates vary a great deal across case types even within the sample of federal consumer protection statute class actions. For example, even under a single statute, such as the Fair Debt Collection Practices Act, claims rates vary from an average of only 16 percent in cases alleging a debt collector failed to follow statutory formalities to a full 47 percent in settlements of allegations that the debt collector attempted to collect on a legally uncollectible debt.

The CFPB finding that is entirely out of line with my own ongoing research is that attorney fees are only 21 percent of the aggregate payment to the class. In class settlements under federal consumer protection statutes that I have studied, attorney fees are rarely less than 75 percent of the total amount paid to the class and often are equal to three or four times that amount paid to the class. This finding indicates that class action settlements are an extremely costly and inefficient way of getting money to class members. To see how inefficient, one needs only to ask the question: "who would pay their lawyer three times the amount that they themselves actually recovered?"

The reason why the CFPB found to the contrary that attorney fees on average are only a small fraction of the amount paid to class members is because it computed an aggregate average, adding up fees in the numerator and payouts in the denominator across all types of class action settlements in its dataset. On this approach, the statistics from the biggest, monster class settlements swamp the numbers and conceal what are generally much higher fees and much lower payouts to the class. As the CFPB itself reported, attorney fees in the monster class settlements, those exceeding $100 million, averaged only 9 percent of the total payout to consumers but averaged a full 57 percent in settlements of less than $100,000. A mere six class action settlements with a total class payout of $812 million and millions of class members make up 83% of total cash payouts in the 251 settlements studied by the CFPB. When the CFPB reported that attorney fees are a relatively low fraction of class payout and the class claims (or payout) rate relatively high, it was really saying that for six monster settlements, costs were low and payouts high.

The distorting effect of the biggest class action settlements is even more serious than this, because many of the largest settlements did not generate a cash payout to class members but instead brought other "nonmonetary" relief. In order to secure judicial approval of a settlement with primarily non-monetary relief, expert economist witnesses attach a big dollar value to such nonmonetary relief, but the "relief" is often illusory. For example, of the 350 million consumers that the CFPB reported as receiving relief of some kind, 190 million were part of a settlement of long running class litigation against the credit reporting agency Transunion.[4] Class action lawyers received $18 million in fees in

[4] In re Transunion Privacy Litigation, MDL No. 1350 (N.D. Ill., Sept. 7 2008).

that settlement, but consumers only received six months of credit monitoring and credit reports, the latter of which were already free under the Fair Credit Reporting Act.

Thus as an instrument of actually compensating the class, class action settlements are likely to be much more costly and much less effective than is suggested by the data in the CFPB's 2015 Study. Matters are likely even worse on grounds of creating incentives for fair treatment of consumers. Under current legal standards for judicial approval of a class action settlement, the fact that a class action claim is weak on its substantive legal merits and so likely to lose were it ever actually adjudicated is an argument *supporting* judicial approval of the settlement. Indeed, the typical motion for judicial approval of a large, non-statutory class action settlement in my Northern District of Illinois dataset argues that it would be very costly to fully adjudicate the class claims on the merits and that the claim would face a high probability of being rejected on the merits after such an adjudication. Under this standard, *class action settlements are more likely to be approved, the greater the cost of proceeding with further discovery and litigation, and the more dubious and far-fetched is the plaintiff's claim that she has been wronged.*

Under the kind of AAA arbitration studied by the CFPB, there is no similar standard for a settlement. As far as we know from the CFPB's study, arbitrators either find for the consumer claimant, thus deciding that the consumer has been wronged under the relevant statutory or common law obligations of the parties, or a settlement is reached under the shadow of such a likely finding, or the consumer loses outright. As there are no costs to the consumer and very low costs to the company of proceeding to an actual judgment by the arbitrator (in AAA consumer arbitration, the company pays the arbitrator's fees), arbitral settlements are likely only when the consumer has a very good chance of being to have a valid complaint. Thus arbitral settlements are likely only in cases of actual wrongdoing by a financial services company.

5. Conclusion: Much too Little Is Known about Arbitration and Class Actions to Justify a Ban on Mandatory Arbitration

My conclusion is not that arbitration is necessarily superior to all forms of consumer class actions, but rather that far too little is yet known about the performance of either arbitration or consumer class actions to justify a ban on arbitration.