Making Credit Safer

The case for regulation

It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance your home with a mortgage that has the same one-in-five chance of putting your family out on the street—and the mortgage won't even carry a disclosure of that fact. Similarly, it’s impossible for the seller to change the price on a toaster once you have purchased it. But long after the credit-card slip has been signed, your credit-card company can triple the price of the credit you used to finance your purchase, even if you meet all the credit terms. Why are consumers safe when they purchase tangible products with cash, but left at the mercy of their creditors when they sign up for routine financial products like mortgages and credit cards?

The difference between the two markets is regulation. Although considered an epithet in Washington since Ronald Reagan’s presidency, the “R-word” supports a booming market in tangible consumer goods. Nearly every product sold in America has passed basic safety regulations well in advance of being put on store shelves—but credit products are regulated by a tattered patchwork of federal and state laws that have failed to adapt to changing markets. Moreover, thanks to effective regulation, innovation in the market for physical products has led to more safety and cutting-edge features—but innovation in financial products has produced incomprehensible terms and sharp practices that have left families at the mercy of those who write the contracts.

Sometimes consumer trust in a creditor is well placed. Credit has provided real value for millions of households, permitting the purchase of homes that can add to family wealth accumulation and cars that...
can expand job opportunities. Credit can also provide a critical safety net, a chance for a family to borrow against a better tomorrow when they confront layoffs or medical problems today. Life insurance and annuities also can greatly enhance a family’s security. Consumers may not spend hours poring over the details of their credit-card terms or understand every paper they sign at a real-estate closing, but many of those financial products are offered on fair terms that benefit both seller and customer.

But for a growing number of families steered into over-priced credit products and misleading insurance plans, trust in a creditor proves costly. And for families tangled up with truly dangerous financial products, the result can be wiped-out savings, lost homes, costlier car insurance, job rejections, troubled marriages, bleak retirements, and broken lives.

Consumers entering the market to buy financial products should enjoy the same protection as those buying household appliances. Just as the Consumer Product Safety Commission (CPSC) protects buyers of goods and supports a competitive market, a new regulatory agency is needed to protect consumers who use financial products. The time has come to recognize that regulation can often support and advance efficient and more dynamic markets.

AN EPIDEMIC OF CREDIT PROBLEMS
Americans are drowning in debt. One in every four families reports worries about how to pay credit-card bills this month. Nearly half of all credit-card holders missed payments in 2006 (the latest year for which data are available), and an additional 2.1 million families missed at least one mortgage payment. In 2006, a then-record 1.3 million families received foreclosure notices, followed by another 2.2 million families who were in foreclosure in 2007.

Families’ troubles are compounded by substantial changes in the credit market that have made debt far riskier for consumers today than a generation ago. The effective deregulation of interest rates, coupled with innovations in credit charges—including teaser rates, negative amortization, increased use of fees, cross-default clauses, and penalty interest rates—have turned ordinary credit transactions into devilishly complex undertakings. Aggressive marketing compounds the difficulty, shaping consumer demand in unexpected and costly directions. Yet consumers’ time and expertise have not expanded to meet the demands of a changing credit marketplace. Instead, consumers sign on to credit products with only a vague understanding of the terms.

Credit cards offer a glimpse at the costs imposed by a rapidly growing credit industry. In 2006, for example, Americans turned over $89 billion in fees, interest payments, added costs on purchases, and other charges associated with their credit cards. That is $89 billion out of the pockets of ordinary middle-class families, people with jobs, kids in school, and groceries to buy. That is also $89 billion that didn’t go to new cars, new shoes, or any other goods or services. To be sure, the money kept plenty of bank employees working full time, and it helped make debt collection one of the fastest-growing occupations in the economy.

Not all costs associated with debt are measured in dollars. Anxiety and shame have become constant companions for Americans struggling with debt. Since 2000, families have filed nearly 10 million petitions for bankruptcy. Today about one in every seven families is dealing with a debt collector. Mortgage foreclosures and credit defaults sweep in millions more families. How do they feel about their inability to pay their bills? In 2005, the National Opinion Research Council asked families about negative life events: the death of a child and being forced to live on the street or in a shelter topped the list, but filing for bankruptcy ranked close behind, more serious than the death of a close friend or separating from a spouse. Of those who file for bankruptcy, 85 percent struggle to hide the fact from families, friends, or neighbors.

Why do people get into debt in the first place? People know that credit cards are dangerous, all the more so if they carry a balance. Any consumer who signed mortgage papers without reading carefully or seeking legal assistance should not be surprised if terms come to light later that are unfavorable to the consumer. Payday lenders have a bad reputation for taking advantage of people; no one should expect to be well treated by them. Car lenders, check-cashing outlets, overdraft protection—the point can be repeated again and again: Financial products are dangerous, and any consumer who is not careful is inviting trouble. And yet, dangerous or not, millions of Americans engage in billions of credit transactions adding up to trillions of dollars every year.

SETTING THE SNARE
Some Americans claim that their neighbors are drowning in debt because they are heedless of the risk—and there can be no doubt that some portion of the credit crisis is the result of foolishness and profligacy. But that is not the whole story. Lenders have deliberately built tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt.

Creating safer marketplaces is about making certain that the products themselves don’t become the source of trouble. This means that terms hidden in the fine print or obscured with incomprehensible language, reservation of all power to the seller with nothing left for the buyer, and similar tricks have no place in a well-functioning market.

How did financial products get so dangerous? Part of the problem is that disclosure has become a way to obfuscate rather than to inform. In the early 1980s, the typical credit-card contract was a page long; by the early 2000s, that contract had grown to more than 30 pages of incomprehensible text. The additional language was designed in large part to add unexpected—and unreadable—language that favors the card companies. Mortgage-loan documents, payday-loan papers, car-loan terms, and other lending products are often equally incomprehensible. And this is not the subjective claim of consumer advocates. In a recent memo aimed at bank executives, the vice president of the consulting firm Booz Allen Hamilton observed that most bank products are “too complex for the average consumer to understand.”

Creditors sometimes explain away their long contracts with the claim that they need to protect themselves from litigation. This ignores the fact that creditors have found many other effective ways to insulate themselves from liability. Arbitration clauses, for example, may look benign to the customer, but their point is often to permit the lender to escape the reach of class-action lawsuits. This means the lender can break the law, but if the amounts at stake are small, few customers would ever bother to sue.

Legal protection is only a small part of the proliferating verbiage. For those willing to wade through terms like “LIBOR” and “Cash Equivalent Transactions,” lenders have built in enough surprises in some credit contracts that even successful efforts to understand and assess risk will still be erased. For example, after
47 lines of text explaining how interest rates will be calculated, one prominent credit-card company concludes, “We reserve the right to change the terms at any time for any reason.” Evidently, all that convoluted language was there only to obscure the bottom line: The company will charge whatever it wants. In effect, lenders won’t be bound by any term or price that becomes inconvenient for them, but they will expect their customers to be bound by whatever terms the lenders want to enforce—and to have the courts back them up.

Even worse, consumers wary of creditor tricks may look for help, only to rush headlong into the waiting arms of someone else who will fleece them—and then hand them over to the creditors for further fleecing. For example, consumers may respond to advertisements for “a friend to help you find the best possible mortgage,” “someone on your side,” and “access to thousands of mortgages with a single phone call—do all your comparison shopping here.” When they call a mortgage broker, they may believe he or she will provide wise advice to guide them through a dangerous thicket—and some brokers do just that. But consumers are just as likely to encounter brokers who are working only for themselves, taking what amounts to a bribe from a mortgage company to steer a family into a high-cost teaser-rate mortgage, for example, rather than a 6.5 percent fixed-rate, 30-year mortgage—because the broker can pocket a fee (a “yield service premium,” or YSP) from the company to place the higher-priced mortgage.

Of course, YSPs are not confined to high-fee, high-interest, subprime loan. Pushing a family that qualifies for a 6.5 percent loan into a higher-cost loan and pocketing the difference will cost the family tens of thousands of dollars—but it will not show up in anyone’s statistics on subprime lending. Other creditors have their own techniques for fleecing borrowers. Payday lenders offer consumers a friendly hand when they are short of cash. But buried back in a page of disclaimers for one lender (rather than on the fee page, where the customer might expect to see it) was the note that the interest rate on the loan was 485.450 percent. In transactions recently documented by the Center on Responsible Lending, a $300 loan cost one family $2,700, while another borrowed $400, paid back $3,000, and was being hounded by the payday lender for $1,200 per month when they gave up and filed for bankruptcy. In total, the cost to American families of payday lending is estimated to be $4.2 billion a year. The Department of Defense identified payday lending as such a serious problem for those in military service that it noted that the industry “impaired military readiness.” Congress has now banned all companies from charging military people more than 36 percent interest, while leaving all other families subject to the same predatory practices.

For some, Shakespeare’s injunction “Neither a borrower nor a lender be” seems to be good policy. But no one advocates that people who don’t want their homes burned down should stay away from toasters, or that those who don’t want their fingers toes cut off should give up mowing the lawn. To say that lenders won’t be bound by any term or price that becomes inconvenient for them, but they will expect their customers to be bound by whatever terms the lenders want to enforce—and to have the courts back them up.

Despite the characterization of YSPs by one Fannie Mae Foundation vice president as “lender kickbacks,” Congress and the regulatory agencies have generally approved of these fees under pressure from the mortgage-broker industry. In fact, mortgage brokers face few regulatory restrictions—a critical problem given that they originate more than half of all mortgage loans, particularly at the low end of the credit market. (YSPs are present in 85 percent to 90 percent of subprime mortgages, implying that brokers needlessly push clients into more expensive products.) The costs are staggering: Fannie Mae estimates that fully 50 percent of those who were sold ruinous subprime mortgages would have qualified for prime-rate loans. A study by the Department of Housing and Urban Development revealed that one in nine middle-income families (and one in 14 upper-income families) who refinanced a mortgage ended up with a high-fee, high-interest, subprime loan. Of course, YSPs are not confined to subprime mortgages. Pushing a family that qualifies for a 6.5 percent loan into a higher-cost loan and pocketing the difference will cost the family tens of thousands of dollars—but it will not show up in anyone’s statistics on subprime lending.

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Indeed, the pain imposed by a dangerous credit product is even more insidious than that inflicted by a malfunctioning kitchen appliance. Wealthy families can ignore the traps associated with credit-card debt: their savings will protect them from medical expenses that exceed their insurance coverage or the effects of an unexpected car repair. Working- and middle-class families are far less insulated. For those closer to the economic margin, a credit card with an interest rate that unexpectedly escalates to 29.99 percent or misplaced trust in a broker who recommends a high-priced mortgage can trigger a downward economic spiral from which a family may never recover.

**INSUFFICIENT REMEDIES**

Credit transactions have in fact been regulated by statute or common law since the founding of the Republic. Traditionally
states bore the primary responsibility for protecting their citizens from unscrupulous lenders, imposing usury caps and other credit regulations on all companies doing business locally. Although states still play some role, particularly in the regulation of real-estate transactions, their primary tool—interest-rate regulation—has been effectively destroyed by federal legislation. Today, any lender that gets a federal bank charter can locate its operations in a state with high usury rates (e.g., South Dakota or Delaware) and then export that state’s interest-rate caps (or no caps at all) to customers located all over the country. As a result, and with no public debate, interest rates have been effectively deregulated across the country. In April 2007, the Supreme Court took another step in the same direction in *Watters v. Wachovia*, giving federal regulators the power to shut down state efforts to regulate mortgage lenders—without providing effective federal regulation in turn.

Local laws suffer from another problem. As lenders have consolidated and credit markets have become national, a plethora of state regulations drives up costs for lenders, forcing them to include repetitive disclosures and meaningless exceptions even as it also leaves regulatory gaps. During the 1970s and early 1980s, for example, Congress moved the regulation of some aspects of consumer credit from the state to the federal level through a series of landmark bills that included Truth-in-Lending (TIL), Fair Credit Reporting, and anti-discrimination regulations. These statutes tend to be highly specific: TIL specifies the information that must be revealed in a credit transaction, including the size of the typeface that must be used and how interest rates must be stated. But the specificity of these laws works against their effectiveness, inhibiting some beneficial innovations (e.g., new ways of informing consumers) while failing to regulate dangerous innovations (e.g., no discussion of negative amortization). What’s more, these generation-old regulations completely miss most of the new features of credit products such as universal default (increasing interest rates even when customers are meeting all the terms of their credit agreements) and double-cycle billing (charging interest on money that was repaid).

Any effort to increase or reform regulation of financial products is met by a powerful industry lobby that is not balanced by an equally effective consumer lobby, so even the most basic efforts are blocked from becoming law. A decade ago, for example, mortgage-lender abuses were rare. Today, experts estimate that fraud and deception stripped $9.1 billion in equity from homeowners, particularly from elderly and working-class families, even before the subprime crisis got into full swing. A few hardy souls have repeatedly introduced legislation to halt such practices, but those bills never make it out of committee. Even after a change in control of Congress in 2006, efforts to rein in lenders have made little headway.

Beyond Congress, some regulation of financial products occurs indirectly through the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision—each of which has some power to control certain forms of predatory lending. But their main mission is to protect the stability of banks and other financial institutions, not to protect consumers. As a result, they focus intently on bank profitability, and far less on the financial impact on customers of many of the products the banks sell.

The regulatory jumble creates another problem: consumer financial products are regulated based principally on the identity of the issuer, not on the nature of the product. The subprime-mortgage market provides a stunning example of the resulting fractured oversight. In 2006, for example, 23 percent of such mortgages were issued by regulated thrifts and banks, and another 25 percent by bank holding companies (subject to different federal oversight) —but 52 percent originated with companies with no federal supervision at all, primarily stand-alone mortgage brokers and finance companies. This division also triggers a kind of regulatory arbitrage. Regulators are acutely aware that if they push financial institutions too hard, those firms will simply reincorporate in another form under the umbrella of a different regulatory agency—or none at all. Indeed, in recent years a number of credit unions have dissolved and reincorporated as state or national banks, precisely to fit under a regulatory

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financial products, review new products for safety, and require modification of dangerous products before they can be marketed to the public. The agency could review mortgages, credit cards, car loans, and so on. It could also exercise jurisdiction over life insurance and annuity contracts. In effect, the FPSC would evaluate these products to eliminate the hidden tricks that make some of them far more dangerous than others, and ensure that none pose unacceptable risks to consumers.

An FPSC would promote the benefits of free markets by assuring that consumers can enter credit markets confident that the products they purchase meet minimum safety standards. A commission could collect data about which financial products are least understood, what kinds of disclosures are most effective, and which products are most likely to result in consumer default. It could develop nuanced regulatory responses; some credit terms might be banned altogether, while others might be permitted only with clearer disclosure. A commission could promote uniform disclosures that make it easier to compare products, and to discern conflicts of interest on the part of a mortgage broker or seller of what are now loosely regulated products. For example, an FPSC might review the following terms that appear in some—but not all—credit-card agreements: universal default clauses; unlimited and unexplained fees; interest-rate increases that exceed 10 percentage points; and an issuer’s claim that it can change the terms after money has been borrowed. It would also promote such market-enhancing practices as a simple, easy-to-read paragraph that explains all interest charges; clear explanations of when fees will be imposed; a requirement that the terms of a credit card remain the same until the card expires; no marketing targeted at college students or minors; and a statement showing how long it will take to pay off the balance, as well as how much interest will be paid if the customer makes the minimum monthly payments on the outstanding loan balance.

With every agency, the fear of capture by those it regulates is ever-present. But in a world in which there is little coherent, consumer-oriented regulation of any kind, an FPSC with power to act is far better than the available alternatives. Whether it is housed in a current agency such as the CPSC or stands alone, the point is to concentrate the review of financial products in a single location, with a focus on the safety of the products as consumers use them. Companies that offer good products would have little to fear. Indeed, if they could conduct business without competing with companies whose business model is to mislead the customer, then the vendors offering safer products would be more likely to flourish. Moreover, with an FPSC, consumer-credit suppliers would be free to innovate on a level playing field within the boundaries of clearly disclosed terms and open competition—not hidden terms designed to mislead consumers.

The consumer financial services industry has grown to more than $3 trillion in annual business. Lenders employ thousands of lawyers, marketing agencies, statisticians, and business strategists to help them increase profits. In a rapidly changing market, customers need someone on their side to help make certain that the products they buy meet minimum safety standards. Personal responsibility will always play a critical role in dealing with credit cards or other loans, just as personal responsibility remains a central feature in the safe use of any other product, but a Financial Product Safety Commission would be the consumers’ ally. And for every family that avoids a trap or doesn’t get caught by a trick—that’s regulation that works.

Elizabeth Warren, RF ’02, is Gottlieb professor of law and faculty director of the Program of Judicial Education at Harvard Law School. An earlier version of this article appeared in Democracy: A Journal of Ideas (democracyjournal.org/article.php?ID=6528).

charter that would permit them different options in developing and marketing financial products. If the regulated can choose the regulators they want, it should be no surprise when they game the rules in their favor.

Unfortunately, in a world in which the financial-services industry is routinely one of the top three contributors to national political campaigns, the likelihood of quick action to respond to specific problems and to engage in meaningful oversight is vanishingly slim. This leaves consumers effectively unprotected in a world in which a number of merchants of financial products have shown themselves very willing to take as much as they can by any means they can.

The CPSC’s mission is to protect the public from risks of injury and death from products used in the home, school, and recreation. It has the authority to develop uniform safety standards, order the recall of unsafe products, and ban products that pose unreasonable risks. In establishing the commission, Congress recognized that the complexities of consumer products and the diverse nature and abilities of consumers using them frequently result in an inability of users to anticipate risks and to safeguard themselves adequately."

The evidence clearly shows that the CPSC is cost-effective. Since it was established, product-related death and injury rates in the United States have decreased substantially. The CPSC estimates that standards for three products alone—cigarette lighters, cribs, and baby walkers—save more than $2 billion annually (more than the agency’s total cumulative budget since its inception).

So why not create a Financial Product Safety Commission (FPSC), charged with responsibility to establish guidelines for consumer disclosure, collect and report data about the uses of different financial products, review new products for safety, and require modification of dangerous products before they can be marketed to the public? The agency could review mortgages, credit cards, car loans, and so on. It could also exercise jurisdiction over life insurance and annuity contracts. In effect, the FPSC would evaluate these products to eliminate the hidden tricks that make some of them far more dangerous than others, and ensure that none pose unacceptable risks to consumers.

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