

# Unsafe at Any Rate

*If it's good enough for microwaves, it's good enough for mortgages.  
Why we need a Financial Product Safety Commission.*

**I**t 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 an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street—and the mortgage won't even carry a disclosure of that fact to the homeowner. Similarly, it's impossible to change the price on a toaster once it has been purchased. But long after the papers have been signed, it is possible to triple the price of the credit used to finance the purchase of that appliance, even if the customer meets all the credit terms, in full and on time. Why are consumers safe when they purchase tangible consumer products with cash, but when they sign up for routine financial products like mortgages and credit cards they are left at the mercy of their creditors?

The difference between the two markets is regulation. Although considered an epithet in Washington since Ronald Reagan swept into the White House, the

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“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 reaching store shelves. Credit products, by comparison, 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. By comparison, 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. Indeed, 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 and a chance for a family to borrow against a better tomorrow when they hit job layoffs, medical problems, or family break-ups today. Other financial products, such as life insurance and annuities, also can greatly enhance a family’s security. Consumers might not spend hours pouring over the details of their credit card terms or understand every paper they signed 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 who are steered into over-priced credit products, risky subprime mortgages, and misleading insurance plans, trust in a creditor turns out to be costly. And for families who get tangled up with truly dangerous financial products, the result can be wiped-out savings, lost homes, higher costs for car insurance, denial of jobs, troubled marriages, bleak retirements, and broken lives.

Consumers can enter the market to buy physical products confident that they won’t be tricked into buying exploding toasters and other unreasonably dangerous products. They can concentrate their shopping efforts in other directions, helping to drive a competitive market that keeps costs low and encourages innovation in convenience, durability, and style. Consumers entering the market to buy financial products should enjoy the same protection. Just as the Consumer Product Safety Commission (CPSC) protects buyers of goods and supports a competitive market, we need the same for consumers of financial products — a new regulatory regime, and even a new regulatory body, to protect consumers who use credit cards, home mortgages, car loans, and a host of other products.

**Lenders have deliberately built tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt.**

The time has come to put scaremongering to rest and to recognize that regulation can often support and advance efficient and more dynamic markets.

## **Do You Have Credit Problems?**

Americans are drowning in debt. One in four families say they are worried about how they will pay their credit card bills this month. Nearly half of all credit card holders have missed payments in the past year, and an additional 2.1 million families missed at least one mortgage payment. Last year, 1.2 million families lost their homes in foreclosure, and another 1.5 million families are likely headed into mortgage foreclosure this year.

Families' troubles are compounded by substantial changes in the credit market that have made debt instruments far riskier for consumers than they were a generation ago. The effective deregulation of interest rates, coupled with innovations in credit charges (e.g., teaser rates, negative amortization, increased use of fees, cross-default clauses, penalty interest rates, and two-cycle billing), have turned ordinary credit transactions into devilishly complex financial undertakings. Aggressive marketing, almost nonexistent in the 1970s, compounds the difficulty, shaping consumer demand in unexpected and costly directions. And yet consumer capacity—measured both by available time and expertise—has 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 in the American economy. To be sure, the money kept plenty of bank employees working full-time, and it helped make "debt collector" one of the fastest-growing occupations in the economy. But debt repayment has become a growing part of the American family budget, so much so that now the typical family with credit card debt spends only slightly less on fees and interest each year than it does on clothing, shoes, laundry, and dry-cleaning for the whole family.

Nor are all costs associated with debt measured in dollars; not surprisingly, the effect on family life is considerable. 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 in America 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? The National Opinion Research Council asked families about negative life events, on a ranking of one thorough 100: Death of a child (94.3) and being forced to live on the street or in a shelter (86.7) topped the list, but filing for bankruptcy ranked close behind (83.5), more serious than death of a close friend (80.8) or separating from a spouse (82.1). About half won't tell a friend their credit card balances, and 85 percent of those who file for bankruptcy are struggling to hide that fact from families, friends, or neighbors.

Why do people get into debt trouble in the first place? People know that credit cards are dangerous, all the more so if the customer carries a balance. Mortgage financing is a serious undertaking, with reams of documents and papers; any consumer who signed 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 treated well 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.

Some Americans claim that their neighbors are drowning in debt because they are heedless of the risk or because they are so consumed by their appetites to purchase that they willingly ignore the risks. Surely, in such circumstances, it is not the responsibility of regulators to provide the self-discipline that customers lack. Indeed, there can be no doubt that some portion of the credit crisis in America is the result of foolishness and profligacy. Some people are in trouble with credit because they simply use too much of it. Others are in trouble because they use credit in dangerous ways. 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.

To be sure, creating safer marketplaces is not about protecting consumers from all possible bad decisions. Instead, it is about making certain that the products themselves don't become the source of the trouble. This means that terms hidden in the fine print or obscured with incomprehensible language, unexpected terms, reservation of all power to the seller with nothing left for the buyer, and similar tricks and traps 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. According to the *Wall Street Journal*, 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 terms were not designed to make life easier for

the customer. Rather, they were designed in large part to add unexpected—and unreadable—terms that favor 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 the consumer advocacy movement. In a recent memo aimed at bank executives, the vice president of the business 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 for liability for their own wrongdoing. 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—say, under \$50 per customer—few customers would ever bother to sue.

Legal protection is only a small part of the proliferating verbiage. For those willing to wade through paragraph after paragraph replete with 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 be erased by the lender’s own terms. So, 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, such text is an effort for lenders to have it both ways. 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 in case of dispute.

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. In the mortgage market, 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 they will receive wise advice that will guide them through a dangerous thicket. Some mortgage brokers will do just that. But consumers are just as likely to encounter a broker who is working only for himself, taking what amounts to a bribe from a mortgage company to steer a family into a higher-priced mortgage than it could qualify for,

all the while assuring the family that this is the best possible deal. For example, a family that might qualify for a 6.5 percent fixed-rate, 30-year mortgage could easily end up with a 9.5 percent mortgage because the broker can pocket a fee (what the industry calls a “yield service premium,” or YSP) from the mortgage company to place the higher-priced loan. High YSPs helped drive the wild selling that led to the recent meltdown in the subprime mortgage market.

Despite the characterization of YSPs by one Fannie Mae vice president as “lender kickbacks,” the practice of taking these fees is legal. Under pressure from the mortgage-broker industry, Congress and the regulatory agencies have generally approved of YSPs. In fact, mortgage brokers face few regulatory restrictions. It is no surprise, then, that mortgage brokers originate more than half of all mortgage loans, particularly at the low-end of the credit market. YSPs are present in 85 to 90 percent of subprime mortgages, which implies that brokers are needlessly pushing clients into more expensive products. And 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 home mortgage ended up with a high-fee, high-interest subprime mortgage. Of course, YSPs are not confined to subprime mortgages. Pushing a family who qualifies for a 6.5 percent loan into a 9.5 percent 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 sub-prime lending.

Other creditors have their own techniques for fleecing borrowers. Payday lenders offer consumers a friendly hand when they are short of cash. But hidden in the tangle of disclosures is a staggering interest rate. For example, buried in a page of disclosures 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 offered loan was 485.450 percent. For some families, the rates run even higher. 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

**Financial products should be subjected to the same routine safety screening that now governs the sale of every toaster.**

identified payday lending as such a serious problem for those in the military that it determined the industry “undermines military readiness.” In fact, the practices were so outrageous that Congress banned all companies from charging military people more than 36 percent interest. This change in the law will protect military families from payday lenders, but it will leave all other families subject to the same predatory practices.

For some, Shakespeare’s injunction that “neither a borrower nor a lender be” seems to be good policy. Just stay away from all debt and avoid the trouble. But no one takes that position with tangible consumer goods. 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 and toes cut off should give up mowing the lawn. Instead, product safety standards set the floor for all consumer products, and an active, competitive market revolves around the features consumers can see, such as price or convenience or, in some cases, even greater safety. To say that credit markets should follow a *caveat emptor* model is to ignore the success of the consumer goods market—and the pain inflicted by dangerous credit products.

Indeed, the pain imposed by a dangerous credit product is even more insidious than that inflicted by a malfunctioning kitchen appliance. If toasters are dangerous, they may burn down the homes of rich people or poor people, college graduates or high-school dropouts. But credit products are not nearly so egalitarian. Wealthy families can ignore the tricks and traps associated with credit card debt, secure in the knowledge that they won’t need to turn to credit to get through a rough patch. Their savings will protect them from medical expenses that exceed their insurance coverage or the effects of an unexpected car repair; credit cards are little more than a matter of convenience. Working- and middle-class families are far less insulated. For the family who lives 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 push a family into a downward economic spiral from which it may never recover.

## **The Traditional Solutions Have Hit Their Limits**

The credit industry is not without regulation; credit transactions have 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. While 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), then export that states' 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, leaving the states powerless to act. In April of this year, 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 to replace it.

Local laws suffer from another problem. As lenders have consolidated and credit markets have gone national, a plethora of state regulations drives up costs for lenders, forcing them to include repetitive disclosures and meaningless exceptions in order to comply with differing local laws, even as it also leaves open regulatory gaps. The resulting patchwork of regulation is neither effective nor cost-effective. During the 1970s and early 1980s, for instance, 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, for example, 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, trapping the regulations like a fly in amber. The statutes inhibit some beneficial innovations (e.g., new ways of informing consumers) while they fail 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, double-cycle billing, and other changes in credit.

Any effort to increase or reform statutory regulation of financial products is met by a powerful industry lobby on one side that is not balanced by an equally effective consumer lobby on the other. As a result, 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 have stripped \$9.1 billion in equity from homeowners, particularly from elderly and working-class families. A few hearty souls have repeatedly introduced legislation to halt such practices, but those bills never make it out of committee.

Beyond Congress, some regulation of financial products occurs through the indirect mechanism of the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision. Each agency, for example, has some power to control certain forms of predatory lending. But their main mission is to protect the financial 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 current regulatory jumble creates another problem: Consumer financial products are regulated based, principally, on the identity of the issuer, rather than the nature of the product. The subprime mortgage market provides a stunning example of the resulting fractured oversight. In 2005, for example, 23 percent of subprime mortgages were issued by regulated thrifts and banks. Another 25 percent were issued by bank holding companies, which were subject to different regulatory oversight through the federal system. But more than half—52 percent, to be exact—of all subprime mortgages originated with companies with no federal supervision at all, largely stand-alone mortgage brokers and finance companies. This division not only creates enormous loopholes, it also triggers a kind of regulatory arbitrage. Regulators are acutely aware that if they push financial institutions too hard, those institutions will simply reincorporate in another form under the umbrella of a different regulatory agency—or no regulatory agency 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 charter that would give them different options in developing and marketing financial products. If the regulated have the option to choose their regulators, then it should be no surprise when they game the rules in their own favor.

Unfortunately, in a world in which the financial services industry is routinely one of the top three contributors to national political campaigns, giving \$133 million over the past five years, the likelihood of quick action to respond to specific problems and to engage in meaningful oversight is vanishingly slim. The resulting splintered regulatory framework has created regulatory loopholes and timid regulators. This leaves the American consumer 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 Financial Product Safety Commission**

Clearly, it is time for a new model of financial regulation, one focused primarily on consumer safety rather than corporate profitability. Financial products should be subject to the same routine safety screening that now governs the sale of every toaster, washing machine, and child's car seat sold on the American market.

The model for such safety regulation is the U.S. Consumer Product Safety Commission (CPSC), an independent health and safety regulatory agency founded in 1972 by the Nixon Administration. The CPSC's mission is to protect the American public from risks of injury and death from products used in the

home, school, and recreation. The agency 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 CPSC is a cost-effective agency. Since it was established, product-related death and injury rates in the United States have decreased substantially. The CPSC estimates that just three safety standards for three products alone—cigarette lighters, cribs, and baby walkers—save more than \$2 billion annually. The annual estimated savings is more than CPSC’s total cumulative budget since its inception.

So why not create a Financial Product Safety Commission (FPSC)? Like its counterpart for ordinary consumer products, this agency would be charged with responsibility to establish guidelines for consumer disclosure, collect and report data about the uses of different financial products, review new

financial 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 a number of other financial products, such as life insurance and annuity contracts. In effect, the FPSC would evaluate these products to eliminate the hidden tricks and traps that make some of them far more dangerous than others.

An FPSC would promote the benefits of free markets by assuring that consumers can enter credit markets with confidence that the products they purchase meet minimum safety standards. No one expects every customer to become an engineer to buy a toaster that doesn’t burst into flames, or analyze complex diagrams to buy an infant car seat that doesn’t collapse on impact. By the same reasoning, no customer should be forced to read the fine print in 30-plus-page credit card contracts to determine whether the company claims it can seize property paid for with the credit card or raise the interest rate by more than 20 points if the customer gets into a dispute with the water company.

Instead, an FPSC would develop precisely such expertise in consumer financial products. A commission would be able to 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. Free of legislative

**Customers need someone on their side to help make certain that the financial products they buy meet minimum safety standards.**

micromanaging, it could develop nuanced regulatory responses; some terms might be banned altogether, while others might be permitted only with clearer disclosure. A Commission might promote uniform disclosures that make it easier to compare products from one issuer to another, and to discern conflicts of interest on the part of a mortgage broker or seller of a currently loosely regulated financial product. In the area of credit card regulation, for example, an FPSC might want to review the following terms that appear in some—but not all—credit card agreements: universal clauses; unlimited and unexplained fees; interest rate increases that exceed 10 percentage points; and an issuer’s claim that it can change the terms of cards 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 people under age 21; 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 balance on a credit card.

With every agency, the fear of regulatory capture 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 like 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 involves misleading the customer, then the companies offering safer products would be more likely to flourish. Moreover, with an FPSC, consumer credit companies 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 financial products they buy meet minimum safety standards. A Financial Product Safety Commission would be the consumers’ ally.

## **A Well-Regulated Market**

When markets work, they produce value for both buyers and sellers, both borrowers and lenders. But the basic premise of any free market is full information.

## UNSAFE AT ANY RATE

When a lender can bury a sentence at the bottom of 47 lines of text saying it can change any term at any time for any reason, the market is broken.

Product safety standards will not fix every problem associated with consumer credit. It is possible to stuff a toaster with dirty socks and start a fire, and, even with safety standards, it will remain possible to get burned by credit products. Some people won't even have to try very hard. But safety standards can make a critical difference for millions of families. Families who are steered into higher-priced mortgages solely because the broker wanted a higher fee would have a greater chance of buying—and keeping—a home. A student who wanted a credit card with a firm credit limit—not an approval for thousands of dollars more of credit and higher fees and interest—could stay out of trouble. An older person who needed a little cash to make it until her Social Security check arrived would have a manageable loan, not one that would escalate into thousands of dollars in fees.

Industry practices would change as well. Corporate profit models based on marketing mortgages with a one-in-five chance of costing a family its home would stop. Credit card models that lure 18-year-olds with no income and no credit history into debt with promises of “no parental approval”—on the assumption that their parents will pay it off, rather than see their children begin their adult lives with ruined credit histories—would stop. Rollovers that can turn a simple loan into a mountain of debt would stop.

Personal responsibility will always play a critical role in dealing with credit cards, just as personal responsibility remains a central feature in the safe use of any other product. But a Financial Product Safety Commission could eliminate some of the most egregious tricks and traps in the credit industry. And for every family who avoids a trap or doesn't get caught by a trick, that's regulation that works. **D**