Product Safety Regulation as a Model for Financial Services Regulation

Because of product safety regulations, exploding toasters and other dangerous products are rare in the American marketplace. Despite the fact that financial products can also be dangerous, with terms as incomprehensible as an electrical wiring diagram, regulation is far less comprehensive. Most financial regulation turns on the identity of the issuer—federal bank, state thrift, and private issuer—rather than on the product itself. Instead of using safety experts, financial products are regulated mainly by agencies whose principal responsibility is to protect the profitability of the financial institutions that issue the products. A Financial Product Safety Commission would provide coherent regulation of financial products, eliminating their most dangerous features.

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 would not even carry a disclosure of that fact. Similarly, it is impossible for the seller to change the price on a toaster once the customer has purchased it. But long after the credit card slip has been signed, the credit card company can triple the price of the credit used to finance your purchase. 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?

Differing legal paradigms have created wholly different markets. Nearly every physical product sold in America has passed basic safety regulations well in advance of being put on store shelves. Thanks to effective regulation, innovation in the market for physical products has led both to more safety and to cutting-edge consumer-pleasing features. But credit products are creatures of contract law, thinly regulated by a tattered patchwork of federal and state laws that has failed to adapt to changing markets. As a result, innovation in financial products has produced incomprehensible

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An earlier version of this article appeared in Democracy: A Journal of Ideas, Summer 2007.

ISSN 0022-0078
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terms and sharp practices that have left families at the mercy of those who write the contracts.

The consumer credit industry refers to its various offerings as "financial products," an apt term for something sold to the public with none of the give-and-take negotiations associated with a contract. Acquiring a credit card is as take-it-or-leave-it as acquiring a toaster—no custom features or haggling with the manufacturer over pricing. Missing from the financial products market, however, are basic safety regulations that protect consumers in other markets from exploding toasters, collapsing car seats, and tainted meat.

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—a Financial Product Safety Commission (FPSC)—would protect consumers who use financial products.

For a growing number of families steered into overpriced credit products and misleading insurance plans, the market is not working. 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. Regulation can make the market for financial products more efficient and more dynamic while preventing substantial suffering for millions of Americans.

SETTING THE SNARE

Americans are drowning in debt. Forty percent of families worry whether they can make all their payments this month (Consumer Federation of America 2007). Nearly half of all credit card holders have missed payments in 2006 (the latest year for which data are available) (Konrad 2006), and an additional 2.1 million families missed at least one mortgage payment (Block 2007). In 2006, a then-record 1.3 million families received foreclosure notices, followed by another 2.2 million families that faced foreclosure in 2007 (Credit & Collections World 2008).

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—has 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.

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 ten million petitions for bankruptcy. Today about one in every seven families is dealing with a debt collector (Smith 2005). 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 to rank 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 came close behind, more serious than the death of a close friend or separating from a spouse (Lazarony 2006). Of those who file for bankruptcy, eighty-five percent struggle to hide the fact from families, friends, or neighbors (Warren and Tyagi 2003).

Why are Americans in so much financial trouble? 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 do not 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.

Financial products have become more dangerous in part because 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 thirty pages of incomprehensible text (Pacelle 2004). Much of the additional language added unexpected—and unreadable—terms favoring the card companies. Mortgage loan documents, payday loan papers, car loan contracts, and other lending products are often equally incomprehensible. And this is not merely 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” (Strategy + Business 2006).

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 such as "LIBOR" and "Cash Equivalent Transactions," lenders have built enough surprises in some credit contracts so that even painstaking efforts to understand and assess risk will still be erased. For example, after forty-seven 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 the worst tradition of contract law, lenders do not want to 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," only to end up with a mortgage broker who promotes a product that is good for the broker but lousy for the customer (Carr and Kolluri 2001). Payday lenders offer consumers a friendly hand when they are short of cash. But buried back 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 loan was 485.450 percent (Department of Defense 2006).

For some, Shakespeare’s injunction "neither a borrower nor a lender be" seems to be good policy. But no one advocates that people who do not want their homes burned down should stay away from toasters, or that those who do not want their fingers and toes cut off should give up mowing the lawn. 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. 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 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.

During the 1970s and early 1980s, 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, Fair Credit Reporting, and antidiscrimination regulations. These statutes tend to be highly specific: Truth in Lending 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 is more, these generations-old regulations completely miss most of the new features of credit products such as universal default and double-cycle billing.

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 (Stein 2001), particularly from elderly and working-class families, even before the subprime crisis got into full swing. A few hearty souls have repeatedly introduced legislation to halt such practices (e.g., HR 3974: The Prohibit Predatory Lending Act, 2004; HR 1182: The Prohibit Predatory Lending Act 2005), but those bills never made 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, twenty-three percent of such mortgages were issued by regulated thrifts and banks, and another twenty-five percent by bank holding companies (subject to different federal oversight)—but fifty-two percent originated with companies with no federal supervision at all, primarily stand-alone mortgage brokers and finance companies (Ip and Paletta 2007). 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 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 own favor.

In a world in which the financial service 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 (Congressional Quarterly Money Line 2008). 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.

A FINANCIAL PRODUCT SAFETY COMMISSION

It is time for a new model of financial regulation, one focused primarily on consumer safety rather than on corporate profitability. The model for such regulation is the U.S. CPSC, an independent agency founded in 1972 during the Nixon administration. The CPSC’s mission is to protect the public from risks of injury and death from products used in the home, school, and recreation (U.S. Consumer Product Safety Commission 2003). 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" (Javitt and DeFrancesco 2001).

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).

Why not create an 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.

An FPSC would promote the benefits of free markets by ensuring that consumers can enter financial services 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 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 ten 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, restricting 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 federal 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 against companies whose business models include misleading 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 deceive consumers.

The consumer financial services industry has grown to more than $3 trillion in annual business (Government Accountability Office 2006). Lenders employ thousands of lawyers, marketing experts, 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 financial services products, 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. Lenders may resist, but instead of fighting to shut down a few more bad practices only to watch worse practices take their place, a fight to create an agency to focus on financial product safety is a fight worth having.

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