HARVARD LAW SCHOOL
CAMBRIDGE, MASSACHUSETTS

ELIZABETH WARREN
LEO GOTTLIEB PROFESSOR OF LAW

PHONE: 617 495 3101
FAX: 617 496 6118
EWARREN@LAW.HARVARD.EDU

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My name is Elizabeth Warren. I'm the Leo Gottlieb Professor of Law at Harvard University and the Chair of the Congressional Oversight Panel.

Washington is a complicated place, and this Committee deals with its fair share of complicated issues. But we are here today because of a problem that can be explained in five blunt words: the credit market is broken.

That problem not only caused the current financial crisis, but it threatens to perpetuate the crisis and also trigger similar economic tragedy in the future.

I'm not here today to talk about everyone who has gotten into trouble on a credit card or who has a mortgage that is too big. The need for personal responsibility is as strong as ever. If someone goes to the mall and charges thousands of dollars to buy things they can't afford, they should have to deal with the consequences. And if someone signs on to buy a five-bedroom home with a spa bath and a media room that they can't afford, they should lose it.

We are here today to talk about broken markets—and about the consequences of those broken markets for hard-working, play-by-the-rules families, for financial institutions competing on a skewed playing field, and for our entire economy.

We all know the value of a well-functioning market. It increases efficiencies and produces prosperity. But when a market is broken, the cost is enormous—not just for consumers, but for everyone.

I'm happy to be here today to talk about how I think we can help fix the broken credit market. And I can sum it up in four words: Consumer Financial Protection Agency.

Tricks and Traps Pricing

I've been around long enough to remember the old model of banking. It's a model that most of us grew up with, as I did in Oklahoma. The model was simple and effective: consumers shopped around for products and terms, and lenders evaluated the creditworthiness of potential borrowers before making loans.

Today, the business model has shifted. Giant lenders "compete" for business by talking about nominal interest rates, free gifts, and warm feelings, but the fine print hides the things that really rake in the cash. Today's business model is about making money through tricks and traps.

There are three problems with this new model.

The first problem hits consumers directly. Plain and simple, consumers cannot compare financial products because the financial products have become too complicated. In the early 1980s, the average credit card contract was about a page long. Today, it is more than 30 pages.[1] It would take hours to parse these contracts, and even then, I'm not sure what the customer would know. I am a contract law professor, and I cannot understand some of the fine print. Even people who try to understand their contracts and who do their best to live up to their side of the bargain fall into traps and get stuck with well-hidden risks.

Part of the problem is some bad regulations that encourage fine print. But much of the problem is part of the business plan. Study after study shows that credit products are designed in ways that obscure the meaning and trick consumers.[2] A 2006 study by the Government Accountability Office (GAO) found that "many [credit card holders] failed to understand key aspects of their cards, including when they would be charged for late payments or what actions could cause issuers to raise rates."[3] Moreover, the GAO found that "the disclosures in the customer solicitation materials and card member agreements provided by four of the largest credit card issuers were too complicated for many consumers to understand."[4]

These findings are reinforced by a 2007 study commissioned by the Federal Reserve Board. That study, based on focus group sessions and one-on-one interviews, found that many consumers have difficulty understanding current credit card disclosures.[5] The Federal Reserve identified terms that many consumers did not understand, including:

- many of the numerous interest rates listed;
- when issuers disclose a range of annual percentage rates (APRs), that their specific APR will be determined by their creditworthiness;
- that the APR on a "fixed rate" credit card product can change;
- what event might trigger a default APR;
- what balances the default APR will apply to;
- how long the default APR will apply;
- what fees are associated with the credit card product;
- how the balance is calculated (*i.e.*, two-cycle billing);
- how payments are allocated among different rate balances;
- the meaning and terms of "grace period" and "effective APR";
- the time, on the due date, that payment is due;
- when the introductory rate expires;

- how large the post-introductory rate is; and
- the cost of convenience checks.

The Federal Reserve Board has revised its regulations under the Truth and Lending Act, but there is no indication that credit card contracts will get shorter and more manageable.[6] Even the more effective disclosure designs that were tested in the study and adopted by the Federal Reserve in the proposed revisions to Regulation Z did not eliminate consumer mistakes.[7]

Mortgage products raise the same concerns. A recent Federal Trade Commission (FTC) survey found that many consumers do not understand, or even can identify, key mortgage terms.[8] A survey conducted by the Federal Reserve found that homeowners with adjustable rate mortgages (ARMs) were poorly informed about the terms of their mortgages.[9] Focusing on closing costs, the Department of Housing and Urban Development (HUD) has concluded that, "[t]oday, buying a home is too complicated, confusing and costly. Each year, Americans spend approximately $55 billion on closing costs they don't fully understand."[10] Mortgage lenders furnish reams of unreadable documents shortly before closing, often leaving people with no practical option but to take whatever terms the lender has filled in.

Survey evidence on other consumer credit products similarly suggests that consumers are only imperfectly informed about the relevant characteristics and costs of these products. For example, payday loan customers, while generally aware of finance charges, were often unaware of annual percentage rates.[11] With respect to another consumer credit product, the tax refund anticipation loan, approximately 50% of survey respondents were not aware of the fees charged by the lender. Survey evidence also suggests that "[m]ost consumers do not understand what credit scores measure, what good and bad scores are, and how scores can be improved."[12]

Consumers who face financial documents that do not communicate the basic terms of a credit agreement cannot make accurate predictions about how much risk they are taking on and cannot make effective comparisons among products.

A straightforward comparison among credit products is now impossible. Bank of America offers more than 400 different credit card products alone on its website—and who knows how many more on college campuses, at malls and through the mail? And how many of these cards include terms that permit the lenders to change any of the terms at any time? It makes little sense to invest in a comparison of terms when those terms can change at the next billing cycle. There are plenty of different cards today, but if consumers have no real ability to compare all the terms—particularly those complex terms that result in fees and higher interest—then there is no well-functioning credit market.

Economists of all stripes agree that thriving markets depend on information. The invisible hand of the market works well only when buyers and sellers both have full information about the value of the items they exchange.

Without information, market innovations do not work. For a clear example of this, consider what happened to Citibank. In 2007, under pressure from this very committee, Citibank took an admirable step and made a public pledge to ban universal default and any-time rate changes—practices that had allowed them to raise interest rates on customers who paid on time. Some members of this committee applauded that step. But a year later, Citi realized that, despite all the fanfare, the cards were still so complex that customers could not tell the difference between credit cards with these terms and credit cards without them. Citibank quietly picked the practice right back up again.[13] In a broken market, a better product does not attract buyers.

Good Products Get Lost

The broken credit market also creates problems for the lenders. The lack of meaningful competition has tilted the playing field between small and large institutions. Large institutions have the capacity to spend billions of dollars on advertisements to lure customers from local and regional banks and credit unions—even when those community banks or credit unions are offering better products with fewer—or no—tricks and traps.

Similarly, our existing body of complicated regulations helps large institutions and hurts the smaller ones. While a big institution can hire an army of lawyers and regulatory compliance specialists—and spread the costs over tens of millions of customers—regulatory costs can put enormous financial pressure on a small institution. In addition, as we have learned painfully, large financial institutions can take huge risks—including shaky consumer mortgages and credit cards—knowing that taxpayers will pick up the tab if they fail. Ironically, the taxpayers are often the same customers who have already paid an enormous price for these financial products. By comparison, smaller institutions know that if they take those risks and fail, they will be closed. The FDIC has closed more than 50 small banks just in the past year.[14] Because the comparison among products is not clear, the playing field between big banks and local banks is not level.

Risky Consumer Credit Increases Systemic Risk

Finally, a third problem with the broken credit markets—systemic risk—is a problem that affects everyone—even those who own their homes, don't have a credit card, and wait to buy a car until they have saved the cash. These risky credit products—particularly home mortgages and credit cards—were bundled up, put into trusts, sliced and diced, and sold to bigger financial institutions and eventually to pension funds and municipal governments.

The broken credit market helped create the crisis we are in now—the crisis that has cost Americans their secure pensions, the crisis that has pushed unemployment to 9.4%, the crisis that has frozen small businesses out of the credit market. The broken credit market has put American taxpayers on the hook for billions in subsidies and trillions in guarantees to shore up our largest financial institutions. We have all been hurt. If we do not fix this, we will be hurt again and again.

The last time we had an economic crisis this big was the Great Depression. In response, Congress and the President acted to prevent future disasters. Those new laws gave us fifty years without such a serious financial crisis. We spent those years building a strong middle class. Just like the 73rd Congress that passed FDIC insurance, making it safe for families to put money in banks and pretty much ending bank runs forever, this Congress has the chance to create a safer system for all of us—and for our children and grandchildren. In times of great crisis, narrow interests give way to an American public looking for Congress to get things right. This is an historic moment, and today you have a rare opportunity to bypass those narrow interests and serve the public interest.

What a Consumer Financial Protection Agency Can Do

I am here today because I believe that the establishment of a Consumer Financial Protection Agency is the best way to get things right. Specifically, I believe it will do four things:

Reduce Systemic Risk

First, it will reduce systemic risk. If we don't feed high-risk, high-profit loans into the system, those risks will not get sliced and diced into questionable asset-backed securities and sold throughout the financial system. If we had had a Consumer Financial Protection Agency five years ago, Liar's Loans and no-doc loans would never have made it into the financial marketplace—and never would have brought down our banking system. The economic system took on so much risk—one household at a time—that it destabilized our entire economy. If we stop feeding these high risk loans into the system on the front end, then we're all safe, and we will not need as much new regulation elsewhere in the system.

Reduce Regulatory Burdens

Second, a single regulatory agency watching out for families and individuals can reduce the overall regulatory burden. Right now, we have layers of contradictory, expensive, and sometimes flat-out useless regulations. We need to cut through all that, to authorize one agency to encourage and help develop some plain-vanilla, safe-harbor mortgages, credit cards, car loans and the like that will automatically pass regulatory muster. Picture it—a credit card contract that is two pages long, clear and easy to read, and that has a few well-lit blanks—the interest rate, the penalty rate, when a penalty will be imposed, and how to get the free gift. Each lender can decide how to fill in the blanks for the cards it wants to sell, and each customer can make quick comparisons to see who is offering the best deals. That is a market that works—cheap for the card issuer and good for the customer. Yes, banks could offer something else, but they have to show it meets basic safety rules—things like whether a customer can read it in four minutes or less. It is time to spend less time and less money on regulations that don't work and pass those savings on to the customers.

Foster Innovation

Third, the Consumer Financial Protection Agency will foster innovation. It is important to distinguish good innovation and bad innovation. Figuring out one more trick that boosts company revenues while picking a customer's pocket is not good innovation. Again, the analogy to physical products is useful. The Consumer Product Safety Commission does not permit manufacturers to "innovate" by cutting down on insulation or removing shut off switches. Safety is the baseline, so toaster manufacturers compete by coming up with better products at lower prices. That's innovation that works. Likewise, the proliferation of bad products can in fact hinder the innovation of good products. When the FDA began keeping sugar pills off the market, the pharmaceutical industry had more incentive to innovate and develop those safe products. Again, that is a market that works.

Some are arguing that the Agency will limit consumer choice. They say that consumers should choose the products they want for themselves without Big Brother stepping in. But how can consumers pick the products they want when they are unable to make real comparisons between them? What kind of choice is presented by stacks of paper with incomprehensible legalese—and a billion-dollar ad campaign to sell consumers on the highest-profit items? The Agency will fix the market by putting consumers in a position to make the best decisions for themselves. The financial institutions who have profited from hiding tricks and traps in the fine print may not like reform, but that is what happens when markets work like they should.

Level the Playing Field by Putting Someone on the Consumer's Side

Fourth, the Agency will provide a regulatory home for specialists who care about this issue and whose priority is to level the playing field and give American families a fair shake. We need an agency that allows regulators to make consumers their first priority—not where consumer protection plays second fiddle to bank profitability. We need specialists who won't just be on the bottom rung of an agency dedicated to other priorities.

If you have any doubts about whether a Consumer Financial Protection Agency can work, just look to history.

The FDIC was opposed by the big banks.[15] Would we be better off today if it hadn't been set up to insure deposits?

The FDA gets its fair share of criticism, but would we better off if we could still buy pharmaceuticals from anyone with a bathtub and some chemicals or if no one checked for carcinogens in our cosmetics?

The Consumer Product Safety Commission isn't perfect, but would we better off with fewer protections over infant car seats, bb guns, or lead in children's toys?

People are alive today because agencies made sure that products were safe. Markets work better today because agencies put basic safety regulations in place, so that competition is about things consumers can see. People who charge too much or who buy houses they cannot afford shouldn't be bailed out, but everyone should have a fighting chance to make good financial decisions.

You have a rare opportunity—in this committee and in this Congress—to get things right. Now is the time for a Consumer Financial Protection Agency to repair a broken market, to give families the properly functioning credit market that they deserve, to level the playing field among financial institutions, and to prevent the next economic crisis.

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[1] Brian Grow and Robert Berner, *About that New, "Friendly" Consumer Product*, BusinessWeek (Apr. 30, 2009); Mitchell Pacelle, *Putting Pinch on Credit Card Users*, Wall Street Journal (July 12, 2004). For example, Citibank's credit card agreement was about 600 words—one page of normal type.

[2] For a more detailed discussion of the difficulties customers face in trying to decipher their credit agreements, *see* Oren Bar-Gill and Elizabeth Warren, *Making Credit Safer*, University of Pennsylvania Law Review (2008) (online at www.pennumbra.com/issues/article.php?aid=198). The research from that paper is summarized here.

[3] United States Government Accountability Office (GAO), *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, at 6 (2006) (GAO-06-929) (online at www.gao.gov/new.items/d06929.pdf).

[4] *Id.* Edward Yingling, the President and CEO of the American Bankers Association, admitted that the complexity of their products and contracts confuses consumers. House Subcommittee on Financial Institutions and Consumer Credit, Testimony of Edward Yingling, *Hearing on Credit Card Practices: Current Consumer Regulatory Issues*, 110th Cong. (Apr. 26, 2007) (online at www.house.gov/financialservices/hearing110/htyingling042607.pdf) (acknowledging that the increased complexity of credit cards confuses consumers and can result in a difficult financial situation). Comptroller of the Currency

John Dugan similarly acknowledged that current credit card disclosure rules should be changed to improve consumers' ability to make well-informed decisions. *See* House Subcommittee on Financial Institutions and Consumer Credit, Testimony of John Dugan, *Hearing on Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives*, 110th Cong. (June 7, 2007) (online at www.house.gov/financialservices/hearing110/htdugan060707.pdf). After problems have increased for 30 years, the Federal Reserve Board and Office of Comptroller of the Currency recently made some revisions under TILA. *See* Federal Reserve Board, *Press Release* (May 2, 2008) (online at www.federalreserve.gov/newsevents/press/bcreg/20080502a.htm).

[5] *See* Macro International, *Design and Testing of Effective Truth in Lending Disclosures*, at ii-x (May 16, 2007) (online at www.federalreserve.gov/dcca/regulationz/20070523/Execsummary.pdf) (hereinafter "Disclosure Efficacy Study").

[6] *See* Federal Reserve Board, *Press Release* (May 23, 2007) (online at www.federalreserve.gov/newsevents/press/bcreg/20070523a.htm).

[7] *See* Disclosure Efficacy Study, *supra* note 5 (throughout the report, a comparative qualitative assessment is provided for different disclosure designs; the proposed designs were shown to be more effective, but not fully effective).

[8] *See* James M. Lacko and Janis K. Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, Federal Trade Commission Bureau of Economics Staff Report (June 2007) (online at www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf). For example, 95% of respondents could not correctly identify the prepayment penalty amount, 87% could not correctly identify the total up-front charges amount, and 20% could not identify the correct APR amount.

[9] *See* Brian Bucks and Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?*, Federal Reserve Board, at 26-27 (Jan. 2006) (online at www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf).

[10] U.S. Department of Housing and Urban Development, *News Release* (June 27, 2005) (online at www.hud.gov/news/release.cfm?content=pr05-091.cfm).

[11] *See* Gregory Elliehausen, *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?*, Networks Financial Institute, at 29 (May 2006) (online at www.networksfinancialinstitute.org/Lists/Publication%20Library/Attachments/73/2006-WP-02_Elliehausen.pdf); Gregory Elliehausen and Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand*, Georgetown University Credit Research Center, at 2 (Apr. 2001) (online at www.cfsa.net/downloads/analysis_customer_demand.pdf).

[12] *See* Consumer Federation of America & Providian, *Most Consumers Don't Understand Credit Scores According to a New Comprehensive Survey* (2004).

[13] Eric Dash, *Citibank Considers Repealing a Pledge and a Slogan with It*, New York Times (June 25, 2008) (citing Citibank officer explaining why the company was reinstituting the practices it had dropped).

[14] Federal Deposit Insurance Corporation, *Bank Failures & Assistance* (www.fdic.gov/BANK/HISTORICAL/BANK/index.html) (accessed June 14, 2009).

[15] Mark D. Flood, *The Great Deposit Insurance Debate*, Federal Reserve Bank of St. Louis (July/August 1992) (online at www.research.stlouisfed.org/publications/review/92/07/Deposit_Jul_Aug1992.pdf).