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Testimony of

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Consumer Protection and Middle Class Wealth Building
in an Age of Growing Household Debt

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Introduction

My testimony addresses the reasons that thoughtful consumer protection is a vital necessity to our country's future economic health. In the last two generations, increases in household borrowing and changes in consumer financial services have reshaped the economy. The result is that consumer credit law will be a major determinant of the wellbeing of middle class families for decades to come. To monitor this marketplace and its role in family economic security and the entire economy, lawmakers need the expertise and energy of a dedicated regulator on consumer credit such as the Consumer Financial Protection Bureau.

I am Professor of Law at the University of California, Irvine School of Law. I have worked at several leading law schools, including Harvard Law School and the University of California, Berkeley, School of Law. I have conducted research on household economic security and consumer debt since 2001. My empirical research on abuses in the mortgage servicing industry was among the first efforts to document misbehaviors in foreclosure and bankruptcy cases that violate the rule of law. I am a principal investigator of the 2007 Consumer Bankruptcy Project, the nation's largest study of families that file bankruptcy. I am the author of more than a dozen law review articles on consumer credit issues and am the editor of a forthcoming book, <u>Broke: How Debt Bankrupts the Middle Class</u> (Stanford Univ. Press, 2011).

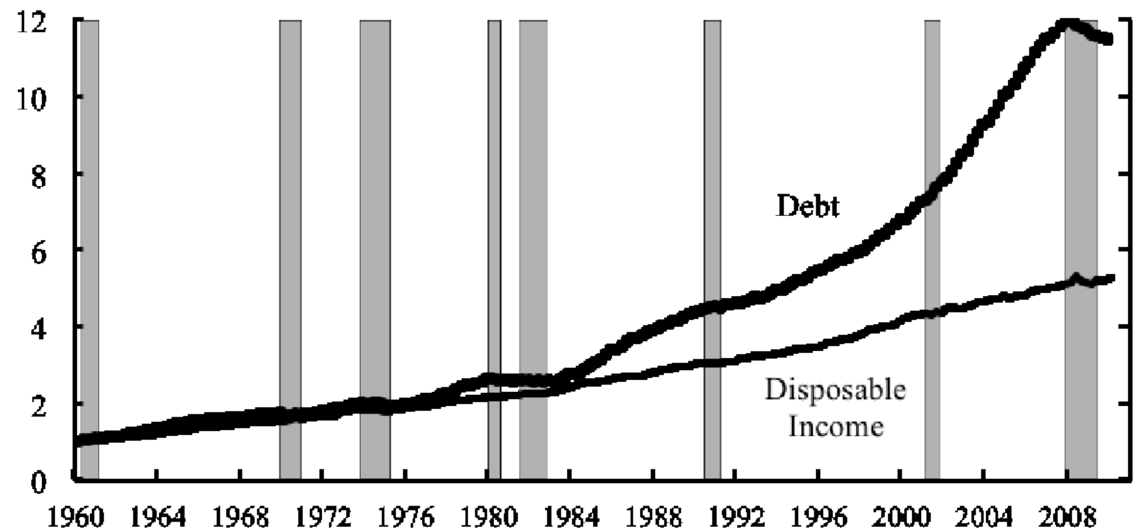
Debt: The New Middle Class Marker

The middle class is a powerful concept. Historically, the size and prosperity of the American middle class has been heralded as a great social and economic achievement. Membership in the middle class is associated with homeownership, educational opportunity, comfortable retirement, access to health care, and last but certainly not least, an appetite for consumer goods.[1] The middle class also has political appeal, as demonstrated by President Obama's decision during his very first week in office to establish a Middle Class Task Force.[2] As chair of the task force, Vice President Biden explained that middle class life is the "old-fashioned notion of the American Dream" and that he and the President "have long believed that you can't have a strong America without a growing middle class. It's that simple. It's that basic."[3] The task force has focused its energy on job creation, retirement security, work-family issues, and higher education.[4]

But the task force has largely ignored a revolutionary change in the lives of middle class Americans: the increase in household debt. In the mid-1980s, the ratio of debt to personal disposable income for American households was 65 percent. During the next two decades, U.S. household leverage more than doubled, reaching an all-time high of 133 percent in 2007.[5] Measured in the aggregate, the ratio of household debt to GDP reached its highest level since the onset of the Great Depression.[6] This record debt burden, which crested just as the financial crisis began, set up families to suffer deeply as foreclosures, unemployment, and wage stagnation set in for the years to follow.

The consumer debt overhang, however, began long before the financial crisis and recession. Exhortations about subprime mortgages reflect only a relatively minor piece of a much broader recalibration in the balance sheets of middle class families. Debt began to climb steeply around 1985, with its growth accelerating in nearly every subsequent year until the onset of the recession. The run-up in consumer debt coincided with a period of deregulation of financial institutions and the preemption of state consumer protection laws and state usury laws that regulated interest rates. Unfortunately for American families, the debt binge was not accompanied by meaningful increases in disposable income. While income crept up, debt shot up, as Figure 1 illustrates. As debt grows relative to income, families must stretch their dollars further to pay for current consumption, while keeping up with debt payments. At some point, income simply becomes insufficient, and families must either curtail spending or default on debt. We are suffering these consequences now, as consumer spending stagnates and families shed debt through foreclosures and default.

Figure 1: *Real Household Debt and Income, 1960 to 2010*



Source: Federal Reserve Board of San Francisco Economic Letter, *U.S. Household Deleveraging and Future Consumption Growth* Number 2009-16 (May 15, 2009)*;* updated data through Q1:2010 courtesy of Federal Reserve of San Francisco.

Note: All series normalized to 1960:Q1. Recession periods shown in gray.

The growth in debt outstripped the appreciation of assets during the last several decades. In other words, increases in liabilities—mortgage debt, home equity lines of credit, student loans, and credit cards—collectively grew faster than increases in assets—houses, cars, stocks, or cash savings. Edward Wolff of the Levy Economics Institute has calculated that as far back as 1995, the amount of mortgage debt began to increase faster than house values.[7] The result of the increased borrowing was to constrain or retard growth in household wealth. Indeed, between 2001 and 2004, the typical (median) American household's wealth actually declined.[8] This was an unprecedented event because the wealth decline occurred during a period of overall economic expansion.

For the middle class, household debt outstripped household asset accumulation. For households with wealth between the 20th and 80th percentiles of the entire distribution, the debt-equity ratio climbed from 37.4 in 1983 to 51.3 in 1998, and then topped off at 61 percent in 2004 and 2007.[9] Whether assessed against income or assets, debt grew in proportion to other changes in families' balance sheets. What looked like a boom economy in the first half of the 2000s actually produced an increase in financial risk for families by loading them with unsustainable debt.

The expansion in borrowing spanned social classes, racial and ethnic groups, sexes, and generations. Every age group, except those 75 years or older, had increased leverage ratios between 1998 and 2007.[10] Similarly, African Americans, Hispanics, and non-Hispanic Whites all saw their leverage ratios grow from 2001 to 2007.[11] This is not to suggest that the debt explosion was equally distributed. For example, between 2004 and 2007, typical people who lacked a high school diploma and typical households headed by a person between ages 65 and 74 had particularly sharp increases in their debt burdens.[12] In particular periods, some groups saw modest declines in consumer debt, but the overwhelming trend was increased amounts of debt among nearly every type of family. By 2007, when debt burdens peaked, 77 percent of American households had some type of outstanding debt.[13] Consumer debt has become one of the most common shared qualities of middle class Americans, usurping the fraction of the population that owns their home, is married, has graduated from college, or attends church regularly.[14]

Too Big to Fail and Too Small to Save: Families in the Recession

As debt increases, so too does the risk of financial failure. This is as true for American families as it is for large corporations, where the catchy phrase "highly leveraged" captures a profound tilt into the red on a balance sheet. The staples of middle class life—going to college, buying a house, starting a small business—carried with them more financial risk in recent decades because they required more borrowing and new riskier forms of borrowing. The escalation in debt turned the smart financial decisions of the prior generation, such as purchasing a home or taking on student loans, into high-stakes economic gambles for middle-class families. Today, millions of Americans are losing those bets, struggling to avoid financial collapse.

One place to see the pain of overindebtedness is in the experience of bankrupt families. Over the long haul, increases in consumer debt seem to explain a significant portion of the increased numbers of consumer bankruptcies.[15] This year approximately 1.4 million families will file bankruptcy.[16] They will publicly "fall from grace," skidding down the economic spectrum.[17] These families' aspirations of middle class security evaporated under pressure from debt collectors, looming foreclosures, and the loss of hope of earning their way out of their financial problems. At least for now, their version of the American Dream has been replaced by a desperate hope that things do not get even worse. Driven by debt, these families are at rock bottom.

Households that file bankruptcy have typically struggled seriously with their debts for the previous one to two years. In fact, many households spent months simply scraping together the money and paperwork needed to file a bankruptcy petition. Nearly all of these families will remember their few minutes with the bankruptcy trustee as one of the most painful moments of their lives. Bankruptcy is a head-on encounter with promises to pay that cannot be honored and privations suffered trying fruitlessly to make ends meet.

Millions of families suffer serious financial hardship but do not file bankruptcy. The number of foreclosures outstrips bankruptcy filings by nearly a two-to-one margin.[18] The

Department of Education reported last month a federal student loan default rate of 8.8% in fiscal 2009, and increase from 7% the previous year.[19] Last year, 140,000 people complained to the Federal Trade Commission about the tactics used by debt collectors, an increase of 28% from 2009.[20] A survey by RAND researchers found that between November 2008 and April 2010 39 percent of families had experienced one or more indicators of financial distress: unemployment, negative equity in their home, or being two months behind on their mortgage or in foreclosure.[21] Debt collection and default are not isolated experiences; they are becoming a routine part of the middle class experience, albeit a painful one. The "new normal" of the U.S. economy—a world of layoffs and job losses, cuts in social programs, and continued housing depreciation—only means that more people will find themselves collapsing under the weight of debts incurred in brighter economic times.[22]

The experiences that are so evident in the wake of the recession highlight the fact that some people will lose the borrowing game that has become the American economy. The consumer spending that drove the economy at the end of the twentieth century was not costless. It was bought and paid for with interest charges, late fees, increased stress about making ends meet, and sometimes, with the humiliation of bankruptcy. Increased consumption was largely financed by debt, rather than by increases in wages or appreciation of assets. Heavy household debt burdens ratchet up risk and reduce the security of the middle-class families.

The consumer debt phenomenon is not a temporary one; it will be a defining feature of American society for decades. It is a fact that consumer debt levels are going down. The "deleveraging" process of paying down debt and increasing savings that began in late 2007 has lasted four years and shows no signs of reversing. The Federal Reserve Board calculates the household debt service ratio for each quarter. This is an estimate of the ratio of debt payments on outstanding mortgages and consumer debt to disposable personal income. In 2011, the ratio declined to levels not seen since the late 1990s.[23] But these levels still remain far beyond those of the prior decades. Overindebtedness is declining but it is not a problem of the distant past, cured by the recession, government stimulus programs, or the enactment of the Dodd-Frank financial reform law.

Retrenchment has been and will be painful—both for families and for lenders. For many families, it has meant homes lost to foreclosure, cars taken in repossession, trade-offs in family time for second jobs, and dunning from debt collectors. Opportunities to launch a new business, attend college, or start a family have been foregone. Changes in credit standards and fears about the consequences of credit have pushed many families further down the economic ladder, reducing assets and consumer confidence. Credit retrenchment, just like the increases in consumer credit in years before, dramatically reshapes the well-being of the middle class.

Consumer confidence is critically affected by consumer debt. The lack of access to credit that is a consequence of the financial crisis is making Americans pessimistic about their futures. In a September 2010 poll, only half of Americans agreed that "the American Dream—that if you work hard you'll get ahead—still holds true"; more than four in ten said it no longer did.[24] This middle-class discontent runs deep and retards efforts to stimulate economic growth. Americans are famously opportunity loving, but even back in 2005 during a robust economy, 62 percent favored the "stability of knowing your present sources of income are protected over concern with the opportunity to make money in the future," which attracted 29 percent of respondents.[25] Problems in managing consumer debt have increased economic anxiety.

Americans' appetite for risk and the aspirations of the middle class reflect in part the financial insecurity of consumer debt levels. With this type of uncertainty, the middle class struggles to hang on, rather than propelling itself forward.

At a conference that I attended, someone quipped that while banks were "too big to fail," families were "too small to save." In part, this comment reflects the powerful importance of the risk frame in public policy, and that small incidences of harm rarely receive the attention of large ones—even if the accumulation of small harms dwarfs the single large harm. This preference to prioritize single large events over multiple smaller ones shortchanges middle class families. For example, the Treasury's bold intervention in the capital markets is a stark contrast to its anemic response to foreclosures at the family level. Neither the Home Affordable Modification Program, nor the government's most recent effort, the Emergency Homeowners' Loan Program, delivered on its promises, with delays in program roll-out and problems in administration. Overall, an estimated less than one million Americans have received a mortgage modification, refinance, or loan from these programs. In that same period, since 2007, over 2 million foreclosures have been completed. Today, estimates are that more than 6 million homeowners are delinquent on their mortgages and 16 million homeowners have no equity in their homes.

Americans are frustrated with the lack of an effective and sustained government response to their financial hardships. Asked in mid-2010 whom government had helped "a great deal" during the downturn, 53 percent of Americans said banks and financial institutions; 44 percent fingered large corporations. Just 2 percent thought economic policies had helped the middle class a great deal.[26] Middle-class Americans feel abandoned. Although their reactions range from anti-government rhetoric to calls for more intervention, people are united across the political spectrum in feeling that government's response to the financial crisis missed the mark. The lack of a government regulator focused on consumer credit, including homeownership markets, is a likely contributor to the feeling that families are too often an afterthought in the design of economic policy.

From Subprime to Safe? Changing Financial Services

The debt loads that are commonplace among today's families would have been simply unthinkable a generation or two ago. While the recession that began in mid-2007 has widened the scope of the financial pain caused by overindebtedness, the problem predated the large-scale economic meltdown that captured headlines. Put another way, the bursting of the housing bubble and subprime loans are not the problem, or certainly not the entire problem, to be solved by consumer protection. The rising levels of household debt and the burdens they impose on families are not about a few bad actors or a couple of innovative loan products gone awry. Certainly, subprime loans and that market are poster children for the need for better oversight of consumer credit. However, they are only one part of a larger revolution in our economy that imposes more debt and more financial risk on families.

The receding financial crisis and the elimination of a subprime mortgage market do not mean that families today enjoy the economic security that traditionally characterized the middle class. Indeed, families today face a level of uncertainty about jobs, taxes, government services, and credit access that leave them in uncharted territory. It is precisely in such an environment that consumer protection law can help families regain confidence in the American economy and make informed and smart financial decisions to build and protect their wealth.

A few examples illustrate the point. In the 1990s and first half of 2000s, home equity loans provided a solution for families who had unexpected expenses or a temporary loss of income. Those products are unavailable to homeowners who are underwater or who have limited equity. This reduction in home wealth leads families to look for other options, such as taking on increased student loans to pay for college rather than refinancing a house to pay tuition. Yet this alternative has its own risks; the generation graduating today and in upcoming years is more likely to have student loans and owe thousands of dollars more than their predecessors. This growing student loan market needs sustained attention and monitoring from the government. Parents and children need financial education on these products and their consequences, and innovative in this market needs monitoring to protect against unfair or deceptive practices.

Another example of ongoing consumer protection issues is changes in retail banking and payment systems. Well before the effective date of the CARD Act in 2010,[27] younger people were more likely to prefer debit cards to credit cards.[28] The industry is rolling out new fees for debit cards, and mobile payments are growing in popularity. These changes mean consumers will have new choices and questions.

Similarly, the growth in debt among older Americans, combined with longer lifespans, mean that retirement is no longer synonymous with economic stability. Millions of seniors owe money on their mortgages, and this group is particularly likely to make use of credit cards. They are also targeted repeatedly in financial scams. As the baby boomers age and they entire retirement in financial positions quite different from the Greatest Generation, their behaviors and needs will change the financial profile of the middle class. These older Americans will look to the government for education about consumer credit and will count on consumer protection laws to shield them from abusive practices that prey on older Americans.

In 2010, Congress created the Consumer Financial Protection Bureau [the "Bureau"].[29] It is specifically charged with monitoring the functioning of the consumer credit markets. Already, the Bureau has developed outreach and education initiatives, perhaps most notably its work on servicemembers and their families. These efforts need to continue and accelerate to help families rebuild after the financial crisis. The Bureau may well have been effective in guarding against the harms of subprime lending but the bankruptcy of subprime lenders and the atrophy of the mortgage market does not eliminate the need for the Bureau. To the contrary, it is precisely in today's uncertain climate that families need a single, visible place to look for financial education.

In its lawmaking functions, the need is similar. Dozens of financial products, including credit cards, debit cards, and student loans are in transition in the wake of the recession and its aftermath. While Congress in Dodd-Frank and the Federal Reserve in its rulemaking have addressed some aspects of the mortgage market, the future of homeownership remains unsettled. We do not know if the 30-year fixed loan will emerge as the sole mortgage product or if a variety of products will proliferate; the market and the regulation of the market will work together to determine these answers. The lesson of the subprime loan market is that there is a grave danger that the federal government will pay insufficient attention to consumer credit markets without a dedicated regulator, and that families and the entire economy can suffer as a result. Families need a powerful voice in these conversations that focus on their wellbeing; the checks and balances that Congress built into the Bureau's design ensure that financial institutions—and their traditional regulators—will also have a voice in determining the future of consumer credit law. That is entirely proper in my opinion. We should guard against weakening the Bureau now that the worst of the financial crisis may be against us. The uncertainty of the future makes the Bureau even more necessary than during the height of the financial crisis when policymakers were focused on acute problems. Government needs to continue to engage in monitoring and regulating consumer credit to help the economy recover and rebuild middle class wealth.

Protecting Middle Class Prosperity

Today, millions of middle class families are experiencing deep economic pain. Consumer debt is not the only reason for the increasing financial vulnerability of Americans; stagnant wages, increased volatility in the labor market, health care and college costs that outpace inflation, and longer life spans that strain retirement savings all play a role. Consumer debt is a powerful force that affects middle class prosperity, however, because in the last two decades debt was the crutch of families wounded by other economic harms. Debt smoothes consumption over time; for example, it can ease the uneven income that characterizes the rising cadre of temporary and contract workers in America. Debt substitutes for cost controls in markets gone astray; for example, people increasingly must finance medical bills because they overwhelm their monthly budgets. Debt fills gaps in making ends meet when social programs erode; for example, people may borrow from a payday lender to cover utility bills as local governments eliminate energy subsidy programs.

These functions for debt are not inherently bad. To the contrary, debt has long been a lynchpin of opportunity in our society. But too many Americans have borrowed too much and that they taken on debts that worsened, rather than improved, their financial situations. In bankruptcies, foreclosures, economic anxiety, and joblessness, we see the harms of consumer debt. The cost of debt is not just the annual percentage rate charged to a family. It is also the social costs of some borrowers becoming hopelessly mired in debt and the macroeconomic effect of overleveraged households. Those costs are being paid by today's middle-class families during the recession and will likely continue to be paid in the upcoming decade. Economic models show that lowering the debt-to-income ratios of households in the next decade and beyond will have significant changes on the macro-economy and its ability to grow through increased consumption.[30] The cumulative result of households' debt burdens is to create a drag on economic growth for the entire nation.

America's relationship with borrowing is at a turning point. Lenders have tightened underwriting standards, and households are reducing their spending and saving more of their incomes. The open question is whether this retrenchment will endure or accelerate. Will America reverse more than two decades of reliance on consumer borrowing and gradually work its way back to debt burdens of the post-War period of prosperity? Or will the borrowing habit return in a few years as the recession recedes, with another boom in borrowing replacing the last few years of bust? The choice between those paths has profound consequences for the economic security of America's middle class.

Congress continues to consider ways to help families with bills such as the Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011, but it should not have to act alone. The executive branch needs to contribute expertise and administrative support. The Bureau is a crucial part of helping to navigate the future of our economy. Through research, rulemaking, and education, the Bureau will provide a roadmap for legislative activity and consumer decision making. It can respond nimbly to the rapid changes that are common in today's turbulent economy and it can help consumers stay informed of changes to markets and laws that could aid them in rebuilding and maintaining wealth.

The Bureau's central mission is to nurture the marketplace for consumer credit, and it's time to allow it to begin its work in earnest by confirming a permanent director and putting to rest efforts to redesign the carefully crafted structure of the Bureau that Congress approved only a year ago. The uncertainty about credit markets is worsened by efforts to dismantle or defang the Bureau. Institutions and industry need a clear path forward, and they need a place to bring concerns about the future of consumer protection regulation. A fully operational Bureau allows families and institutions to adapt and to begin to recover in the wake of the recession and new pressures on families' financial wellbeing.

Conclusion

Going forward, our nation cannot afford to adopt a blind belief that consumer credit markets require little attention. The unmanageable debt burdens that pushed us into a recession and are hampering our recovery powerfully demonstrate that more debt does not equal more prosperity. We cannot sustain national economic prosperity while unmanageable borrowing undermines the prosperity of American families. But neither can we afford to limit opportunity and shunt upward mobility for the middle class by buying into fear that all borrowing is bad or accepting an endless downward spiral of consumer credit. The challenge is to figure out how to calibrate consumer credit markets to balance the harms of borrowing against its benefits. The Consumer Financial Protection Bureau is a critical aspect of meeting that challenge. Its vitality will help our economy recover and flourish, and its vigilance in the future will safeguard the well-being of American families as consumer debt markets change.

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