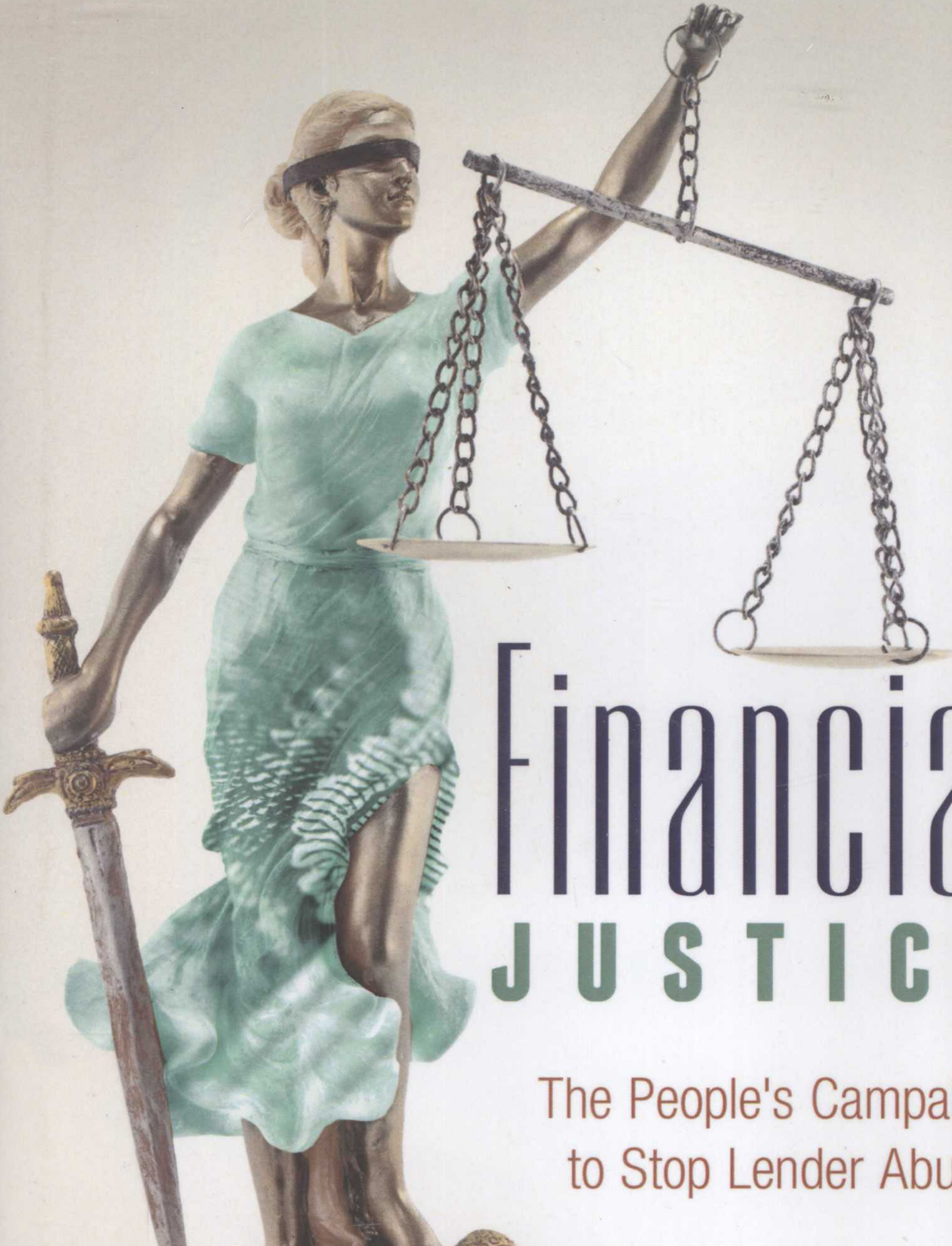

Financial JUSTICE

The People's Campaign to Stop Lender Abuse

LARRY KIRSCH AND ROBERT N. MAYER

FOREWORD BY CONGRESSMAN BARNEY FRANK

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Foreword

It's not unusual for me to read a book where I am in very strong agreement with the basic argument, but have differences with some particular points. It is much less usual for me to be eager to write the foreword to the volume in question. The authors are very kind to me and somewhat critical of some of my colleagues, and I was concerned about the appropriateness of writing a foreword for a book that treated me so much better than a number of other people who I greatly respect. It is possible for Democratic members of the House and the Senate to disagree with the liberal position based on their views of good public policy, and not necessarily because they were influenced by campaign contributions. Substantively, I have one major difference. My opposition to the requirement that financial institutions work for a "plain vanilla" version of any financial product was based on my view that that would be wholly impractical, because I did not—and still do not—see any way to enforce that requirement. But this study of the adoption of the Consumer Financial Protection Bureau makes two very important points—one specific and one general—that far outweigh my disagreements.

The specific point is the importance of creating an independent bureau for the protection of consumers in the financial area. As I write this, the Bureau has already shown its worth, for example in recovering hundreds of millions of dollars for individuals who were mistreated by credit card companies. But the financial interests and their ideological allies in the Congress have not given up the fight against it, and this discussion helps make the case as to why it was needed and why it will be a great asset for our economy.

The broader point is that it shows that democracy can work, even in the face of strong opposition from powerful and wealthy interests. In this regard I welcome it as a refutation of a dangerous self-fulfilling prophecy that is too often uttered by people who would like progressive change in our society.

That prophecy is that politicians don't pay attention to individual voters because they are too beholden to the sources of campaign contributions. It is the philosophy that Elizabeth Warren cited when she said on the day that the Financial Services Committee passed the bill to create the Agency: "They told me not even to try this because the banks always win. But they didn't win today."

Of course, powerful economic interests have a great deal of influence on our political process. They have the money to hire lobbyists, make campaign contributions, and, more importantly than sometimes noted, organize campaigns of their employees. Money is unfortunately all too influential in congressional deliberations, and the outrageous Supreme Court decision in Citizens United has made it even more so. But while it is necessary to recognize that wealthy interests are politically powerful, it is a grave error to act as if they are omnipotent. It is emphatically a major strategic error for those fighting for change to propagate the argument that politicians are so influenced by the money that they will ignore public opinion.

Members of Congress will pay very little attention to opinions that are not expressed. It is also true that it is hard to mobilize the average citizen in many situations, giving the political advantage to those who have a large economic stake. But as this study shows, when individual voters and advocacy groups such as Americans for Financial Reform do express themselves in significant numbers, members of Congress listen.

The Consumer Financial Protection Bureau was established as a strong agency because my congressional colleagues understood that voting for it was better politics than either defeating it or voting for it in a substantially weakened form. This does not mean that it was only electoral considerations that led the members of the House and Senate to vote to create the Agency in 2010. A very large majority of those who voted for it did so because they believed in it strongly. The role of public opinion was not to coerce members who supported strong consumer protection to vote that way, but rather to give them the courage of their convictions, and in particular to enable them to withstand the political pressures being generated by the financial interests that opposed the bill.

The bad news is that money continues to have a significant effect on congressional deliberations, but the good news is that votes can beat money—if the voters are motivated to speak out. It is simply not the case that politicians will ignore a strongly expressed public opinion because big money has captured us all. And to the extent that repeating this argument dissuades citizens from speaking out to their members of Congress, it unfortunately strengthens the very tendency it bemoans.

Congressman Barney Frank

Acknowledgments

First, we extend accolades and appreciation to our interviewees, a remarkable group of public interest advocates, for pursuing their virtuous cause and for being generous with their time and patient with our ignorance. Their comments, we hope, will bring to life the crucial public policy episode covered in this book.

Several people provided valuable feedback on portions of the manuscript and/or assistance in selecting a publisher. Our thanks go to: Andrew Battista, Tom Beck, Betsy Burton, Bob Davis, Clara Greisman, Mel Gurtov, Neal Hirschfeld, Adolfo Lara, Robert Manning, Alan Mayer, Tom Morehouse, Eric Orner, Dick Rahm, Jerry Slepack, and Bob Weinberg. Special thanks go, as well, to Steve Catalano, our editor at Praeger. He believed in the book from the first time we approached him and helped shepherd it seamlessly through the intricate publication process.

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Introduction

Barney Frank, the left-leaning, straight-talking Jon Stewart of the Congress, once reprimanded allies within the consumer advocacy community for being "horseless headmen." The stinging message behind Frank's ironic rebuke was that just having policy smarts without matching political brawn amounted to a losing formula. Following a short but therapeutic spell in the cold tub, advocates stopped crabbing and began organizing. The successful campaign to enact the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was their vindication.

Had the devastating credit collapse of 2008 not sparked a full-blown people's campaign against reckless Wall Street financial practices, embattled borrowers would certainly have been scuppered even more seriously than they were. But consumer, labor, civil rights, fair lending, and community groups in Washington and across the country did come together in a way rarely, if ever, seen before in modern-day citizen politics. What ensued, in the populist narrative, was a pitched battle between newly cemented and sometimes unusual alliances advocating for the "people"—2000s' style—and the traditional leviathans of Wall Street and Big Business.

This book tells the story of a people's campaign to enact serious Wall Street reform and, in particular, to create an independent "cop on the block"—the Consumer Financial Protection Bureau (CFPB)—to safeguard consumers against predatory lending and other financial abuses. In the following chapters we set out to provide a sense of what AFR and its fellow advocates thought, did, and accomplished (and/or failed to bring about). We use a case study approach to illustrate some of the most significant advocacy efforts with respect to the independence, authority, and even existence of a new consumer financial protection agency.

The story is important because it says much about the prospects for successful progressive action in an increasingly sour political environment. It is a story about, and to a large extent told by, the people who made it happen. These activists were drawn largely from the consumer, fair housing, civil rights, and labor movements, and we had unparalleled entrée to them. Their candid on-the-record interview accounts provided us with insights that are rare in social movement and legislative histories. While our primary approach is to recount events through the eyes of the CFPB's advocates, we also try to recognize the views of people who opposed establishing the new, independent agency, relying on published material such as congressional testimony, statements to the press, and articles in law journals.

All authors have opinions and feelings about their subjects, and we gladly admit to ours. Even before writing the book, we were sympathetic to the idea of creating a new consumer financial protection agency. As we conducted research for this book, our prior admiration grew—both for the borrower safeguards enacted in Dodd-Frank and for the extraordinary group of advocates who helped make it a reality. We attempt to provide a fair accounting of all the political actors in this story, but we are clearly in tune with the worldview of the CFPB's champions. If you believe that government action is inevitably ineffectual and that *caveat emptor* is all the protection consumers ever need, then you may find yourself differing with our perspective.

In the course of the three years between when a new agency was proposed and when President Obama signed the bill establishing the CFPB, the names used to describe a new entity to protect consumers in financial transactions changed a number of times. To avoid confusion in the text, we consistently refer to the title of the proposed agency as the CFPB regardless of its name at a given point in the legislative process.

"History is written by the victors," Winston Churchill is supposed to have said with respect to military conflicts. The maxim applies to legislative battles as well. Winners crow; losers clam up. This is the story of the CFPB campaign as told largely by the winners . . . however tenuous their victory may be.

Financial Justice

Contents

Chapter 1

How Did We Ever Get into This Mess?

At the beginning of 2007, the U.S. economy was like the animated cartoon character that runs off a cliff and floats momentarily in mid-air with legs spinning before plummeting to the ground. It's true that, nationally, housing prices had peaked in early 2006, but prices were holding steady in hot markets like California, Nevada, and Arizona.[1] It was, thus, unclear whether the drop in housing prices toward the end of 2006 and into 2007 represented a bump on what had been a dizzying upward ride or the beginning of a sustained national decline.

Some economic policymakers such as Federal Reserve Board chairman Ben Bernanke remained cautiously optimistic about short-term economic prospects. In February 2007, Bernanke reassured a Senate committee that weakness in the housing market had "not spilled over to any significant extent to other sectors of the economy."[2] A month later, he told the Congressional Joint Economic Committee that employment was continuing to expand, and the economies of the United States' major trading partners seemed strong as well.[3]

Soon thereafter, U.S. Treasury Secretary Henry Paulson leavened the forecast just a little bit more. He told an assembled group of business leaders that the housing market correction was at or near its bottom and that problems in the subprime mortgage market were unlikely to spread to the overall economy. In what has since proved to be a colossally incorrect observation, Paulson said: "I don't see [trouble in the subprime mortgage market] imposing a serious problem. I think it's going to be largely contained."[4]

Three Leaders

On May 6, 2007, the Kennedy School of Government at Harvard provided the venue for an academic workshop with the mundane-sounding title, "Managing Risk in the 21st Century." Participants might have found themselves admiring the expansive views of the Charles River on one side and a duo of striking, Oxbridge-inspired, undergraduate residential houses on another. Adding to the bucolic surroundings, there was also the makeshift volleyball court adjacent to the Kennedy School library that provided a relatively safe outlet for Harvard's spirited, highly competitive students and faculty. Inside, however, Harvard Law Professor Elizabeth Warren was anything but playful as she presented her research findings about the impact of abusive lending practices on families and what should be done about it. The name of her paper was "A Fair Deal for Families: The Need for a Financial Products Safety Commission."[5]

Warren's presentation was summarized a month later in a small circulation journal called *Democracy*.[6] The gist of her argument was that in the current environment, a very high percentage of middle-class, often dual-wage-earner, families was at substantial risk of experiencing some type of unexpected and unavoidable financial crisis serious enough to wipe them out. A medical emergency, job loss, or divorce could easily deplete their savings and force them to the maw of the banking and credit system in search of a financial reprieve.

The basic statement of the case presented that day by Professor Warren is not in serious debate; if anything, new studies provide additional evidence for her point that economic insecurity has become an ever more prevalent part of the American scene.[7] Household finances provide an extraordinarily fragile safety net for families facing financial emergencies. Almost half of all people surveyed by a team at the Brookings Institute reported that they would be unable to absorb the costs of even a very modest ($2,000) financial emergency if given 30 days to raise the funds.[8] Keep that number in mind when you reflect on the fact that the bill for a single emergency room visit to have your kid's chin sutured after a bike spill could easily come to $5,000 or more.[9]

The sobering conclusion of Warren's research can be summed up, roughly, in the following way: "Watch out, folks. Once you cross the threshold into the credit and finance system, the rules of the game are not consumer-friendly." Quite the opposite; lenders frequently employ sophisticated business tactics to "trick or trap" borrowers just when they are most vulnerable. And as if that isn't bad enough, Uncle Sam is doing a miserable job policing the marketplace.

Because the mission of the Tobin Project, the sponsor of Warren's workshop talk, is to produce transformative policy research (aimed at finding practical solutions to major societal problems), a highlight of Professor Warren's presentation was a proposal for a new, federal consumer financial protection agency to assure the safety of the credit system for borrowers.[10] Patterned, loosely, after Ralph Nader's 1965 book *Unsafe at Any Speed* and the consumer product safety improvements his exposé jumpstarted, Warren's mantra was basically that it made no sense for consumers to be secure from the hazard of exploding toasters but at risk of incendiary mortgages or credit cards.

One of the discussants of Warren's paper that day in May was Barney Frank, recently sworn in as chair of the U.S. House of Representatives' Financial Services Committee. Frank, a wry Bostonian and Harvard alum (who claimed, unabashedly, to have the longest uncompleted PhD dissertation in the university's history), was assigned the discussant's task of assaying the practical political challenges that would face enactment of a consumer financial protection agency should such a proposal be introduced.[11] Without in any way denigrating Frank's more than ample store of acumen, it would have taken a mind reader to predict the reception given to Professor Warren's proposal when it was actually introduced in Congress. Chairman Frank would soon find that out, first hand. More to the point, he would personally take charge of the Warren proposal and help steer it to final passage under the eponymously titled Dodd-Frank Act.

Shortly before Elizabeth Warren gave her presentation to the Tobin Workshop, Heather Booth, a leader and strategist for a variety of progressive causes, authored a blog post dealing with the future of progressive politics in America. Her basically optimistic article took off from a piece contributed by another Kennedy School faculty member and long-time activist colleague, Marshall Ganz.[12] Serendipitously, Booth's post dovetailed with some of the themes outlined in Elizabeth Warren's subsequent presentation.[13] If Warren played the part of the dramatist, evoking broad themes and sketching a justification for policy change, Booth was the stage director, transforming words into convincing images and carefully choreographed action. The main burden of Booth's remarks was that progressive political change, in the doldrums for such a long time, now enjoyed a better chance of success. This was due, in no small measure, to activists, themselves. By this she meant to suggest that activists had made important advances in building capable leadership, improving modes of communicating, mobilizing a broad membership base, and consolidating issue campaigning with electoral politics—in short, in organizing more effectively.[14]

Booth believed that the fundamental changes in power relations and structures sought by progressives would ultimately have to come about through some degree of engagement with the traditional political system. Therefore, to be successful, activists had to participate in the electoral and legislative processes through ground-level organizing blended with insider legislative lobbying work.[15] Activists needed to do more than identify issues and develop proposals standing on the sidelines of the political fray; they needed to jump in and become part of it.

This proposition, emanating from such a highly respected member of the activist community, would have surely cheered Barney Frank—an important progressive leader himself. Frank periodically found it necessary to goad activist friends and supporters into becoming more politically and strategically engaged—sometimes with brutal honesty. For example, in his comments about the participation of gay rights activists in the 2009 National Equality March, Frank, the first-ever gay member of Congress to come out as a matter of personal choice, told a TV interviewer, "[If activists] want to pressure Congress, I don't know what standing on the Mall on a weekend when no member of Congress is in town is going to do. All that's going to pressure is the grass."[16]

Based on decades of activist leadership, Booth argued that effective advocacy called for measures driven by generally accepted moral principles coupled with a clear demonstration that they would yield practical improvements on important issues in people's lives. And although upbeat about the historic opportunity progressives now had on key foreign and domestic issues, she was nonetheless realistic about the obstacles and opposition that would face any meaningful "democratic revival."

Clearly, the conjunction between the Warren and Booth arguments was very strong in a number of ways—none more important than the shared recognition that proposals for change would have to benefit people in ways which were meaningful to their lives on an everyday basis. For people to take concerted action as citizen-advocates, they would first have to feel the pain and then believe they had the power to do something effective to stop it.

As Elizabeth Warren later observed, while standing on the brink of her personal entry into electoral politics in Massachusetts, "I threw myself into that piece [the *Democracy* article] because I felt strongly that a new consumer agency would make the credit markets work better for American families and strengthen the economic security of the middle class."[17] Indeed, making credit markets more secure and increasing economic well-being for a broad swath of the population were the overarching, tangible goals that united the three leaders: the law professor with activist instincts, the community organizer with group mobilization skills, and the career politician with the position and credibility to drive the legislative process.

The Plascencias: One Family's Story of Lending Abuse

Although the story of the housing bubble has been recounted in great detail elsewhere, a thumbnail illustration of how lenders structured their mortgage products and transacted business with buyers helps to explain why Professor Warren concluded that the mortgage market was dysfunctional and defunct, and why a consumer financial protection agency was so vital.[18]

One typical case involves a couple, then in their mid-40s, named Melania and Armando Plascencia. The couple lived in San Leandro, California, just east of Oakland. The other key players included a California-based lender named Lending 1st Mortgage that issued a mortgage to the Plascencias; a Delaware company, EMC Mortgage, that bought and securitized mortgages from lenders including Lending 1st and sold them to investors; and a number of brokers, agents, and other unnamed players associated with the lenders.

Lending 1st Mortgage, a prototypical mortgage company, set out to design and sell home mortgages for which the monthly payment, not the size of the mortgage loan, was the chief source of appeal to a burgeoning market of folks like the Plascencias. Prospective borrowers included first-time homeowners who were not financially eligible for or willing to pay conventional market rates and, as in the case of the Plascencias, people who wanted to refinance their existing mortgage.

To achieve its sales objectives, Lending 1st used methods that were commonly found in the industry. It wrote Adjustable Rate Mortgages (ARMs) that offered time-limited, promotional (teaser) interest rates and low monthly payments.[19] The combination of low-cost terms and relaxed eligibility provisions earned mortgages like this one the sobriquet of "affordability products." (To other industry watchers, however, these products were sufficiently dangerous to warrant the term "neutron bomb"—signifying the most hazardous mortgage sold in the marketplace.)[20] When prospective borrowers considered the offer Lending 1st put on the table, the features marketers hoped they would observe most keenly included the low, teaser rate and the attractive monthly payment. Combined, these two features screamed "great deal."

The underlying value proposition floated by sellers was that spiraling home prices would continue, buyers would build equity, and refinancing would be easy to obtain when the initial loan terms became too costly. On its face, the basic sales pitch seemed plausible enough. Grievously, for the Plascencias and other borrowers, these assumptions and reality diverged. At a certain point, prices in the various local housing markets tanked and home values fell below the amount due on outstanding mortgages. As low cost, introductory interest rates wore off and were reset to market levels, borrowers began to face higher—in many cases, much higher—monthly payments they could not afford. And as home values fell and dragged owners' equity with it, the refinancing option many borrowers had come to count on was no longer available.

To compound matters, as the Plascencias claimed in a pending class action lawsuit, their lenders both fraudulently misled them and kept them in the dark about important financial provisions and onerous loan conditions. Among them were repayment features which made it virtually impossible for the Plascencias to pay-down the principal on their loan, prepayment penalties which effectively blocked them from canceling their mortgage and cutting their losses, and promotional interest rates which unexpectedly reset after 30 days instead of 2 to 3 years.[21]

The strategy of Lending 1st Mortgage reflected an approach to lending that was regrettably too commonly observed and was at the heart of the mortgage bubble: attract large numbers of borrowers; make loans without regard to the borrower's ability to repay them; offer products, terms and conditions that are not transparent, adequately understood, or fair to borrowers; charge outsize fees; and pass-through financial risk to investors. Elizabeth Warren argued, persuasively, that this business strategy was deformed. She and, later, Booth pointed out in their writings and other presentations that the broken commercial marketplace for consumer credit was unsafe and unfair to borrowers and was a prime contributor to economic insecurity and hardship.

The Failure of Financial Regulators

As unforgiving as Warren and Booth's indictment of mortgage, credit card, and Wall Street lenders may have been, their criticism of federal credit regulators such as the Federal Reserve and the Comptroller of the Currency was hardly more sparing. Their basic argument—and that of many other consumer and fair housing advocates—was that going back to the Reagan era, federal bank regulators, with limited exception, had pursued