Chapter Three

Ethics and the Retail Customer

Virtually everyone is a retail customer of the financial services industry. Banking provides essential services that are needed by most people, and many use credit and debit cards, obtain loans, secure insurance policies, make investments, save for retirement, seek financial planning, and otherwise consume financial services. For much of the financial services industry, retail customers are the main focus of their business, which requires providers to develop and sell products that satisfy their customers' needs and gain their loyalty.

In serving retail customers, the financial services industry relies heavily on personal selling. Although more and more customers are dealing with banks via cash machines and websites, sending their money in envelopes to faceless mutual funds, and saving for retirement through employer withholding, many people still know their local banker, buy and sell securities through a broker whom they know personally, and deal with insurance agents, financial planners, tax advisers, and other finance professionals face to face. Personal selling creates innumerable opportunities for abuse, and although finance professionals take pride in the level of integrity in the industry, misconduct still occurs. However, customers who are unhappy over failed investments or rejected insurance claims, for example, are quick to blame the seller of the product, sometimes unfairly.

In addition to abuses in the selling of financial products, criticism can be leveled at the products themselves. Payday loans, for example, are suspect for exploiting the poor with high rates and practices that often create a vicious cycle of indebtedness. Banks make much of their profit from overdraft fees on debit cards, which can be inflated by certain methods for calculating the charges, while the opportunity to decline overdraft has not been readily

Ethics in Finance, Third Edition. John R. Boatright.

disclosed. Subprime mortgages have been a particular target of criticism during the recent financial crisis for being sold with inducements and without documentation to unwary borrowers who frequently end up "underwater," owing more on a mortgage than the house is worth. Some of the mortgage-backed securities into which these loans were bundled were described at the time as "toxic waste."

There are "bad apples" in every business, of course, but many critics fault the industry itself. They cite the need for better training of sales personnel, more stringent rules and procedures, more aggressive oversight, more disclosure to investors, and changes in the compensation system. The full-service brokerage business, for example, is facing a crisis as wary customers, who have felt vulnerable relying on individual brokers, now have many options for their investment dollars. Mutual funds and even banks now offer investors the opportunity to invest without the fear of being "ripped off" by a broker. The new Consumer Financial Protection Bureau, which was created by the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, has the central mission "to make markets for financial products and services work for Americans."

This chapter examines four issues facing the financial services industry in meeting customer needs, treating customers fairly, building customer confidence, and ensuring a high level of integrity in all aspects of the business. A section on unethical sales practices considers deception, manipulation, and concealment, as well as churning by brokers and similar abuses by insurance agents and loan officers. Credit and debit cards, while generally beneficial, may be problematic for many users because of many abusive practices, which may result, in part, from a lack of disclosure and consumer education by the issuing banks. Mortgage lending, which is critical to home ownership, raises many problems, including discrimination in mortgage lending, called "redlining," which has contributed to urban blight and is the subject of an important piece of legislation, the Community Reinvestment Act. The problem considered here is that of subprime loans, which have not only damaged the lives of many unwary borrowers but played a major role in the recent financial crisis. Finally, many financial products and services require retail customers to submit disputes to arbitration, and this requirement, along with alleged abuses in the arbitration process, has prompted a controversy that is also covered in this chapter.

Sales Practices

Two real estate limited partnerships launched by Merrill Lynch & Co. in 1987 and 1989 lost close to $440 million for 42 000 investor-clients.[1] Known as

Arvida I and Arvida II, these highly speculative investment vehicles projected double-digit returns on residential developments in Florida and California, but both stopped payments to investors in 1990. At the end of 1993, each $1000 unit of Arvida I was worth $125 and each $1000 unit of Arvida II, a mere $6.

Not every investment is a success, of course, and aggressive investors reap higher rewards for assuming greater risk. However, the Arvida partnerships were offered by the Merrill Lynch sales force to many retirees of modest means as safe investments with good income potential. The brokers themselves were told by the firm that Arvida I entailed only "moderate risk," and company-produced sales material said little about risk, while emphasizing the projected performance. Merrill Lynch advised its own brokers that the Arvida funds were appropriate for investors with $30 000 in income and a $30 000 net worth, or with a $75 000 net worth—which is to say, most of the brokers' clients. Left out of the material was the fact that the projections included a return of some of the investors' own capital, that the track record of the real estate company was based on commercial, not residential, projects, and that eight of the top nine managers of the company had left just before Arvida I was offered to the public.

Merrill Lynch (now part of Bank of America) insists that the brokers acted properly in selling the Arvida limited partnerships to clients, but several questions can be raised about the firm's sales practices. First, were some investors *deceived* by the brokers' sales pitches? The prospectus for an offering is typically scrutinized by the Securities and Exchange Commission (SEC) and the issuing firm's legal staff in order to ensure full disclosure of all legally required information. However, investors seldom read all of the fine print and do not always understand what they do read. Much of their understanding of an investment comes from conversations with brokers, and here there is ample opportunity for deception. Second, did the Merrill Lynch brokers have a responsibility to protect the interests of their clients? At one extreme, brokers can be viewed as sellers of a product whose obligations do not extend beyond those of any seller, which include, of course, a prohibition on deception. The other extreme is to view brokers as agents who are pledged to advance the interests of clients to the best of their abilities. However, the responsibilities of brokers lie at neither extreme and vary with the client and circumstances.

What is ethical and unethical in sales practices is difficult to determine in detail because of the many kinds of sellers in the financial services industry. The situation of stockbrokers is different from that of insurance agents or financial planners, for example. Selling is done both by person-to-person contact (including cold calling) and by more anonymous mass-media advertising and direct-mail promotion. However, two issues are ever present, namely whether a sales practice is deceptive and the extent of a seller's responsibility to protect the buyer.

Deception and concealment

The ethical treatment of retail customers requires that salespeople explain all of the relevant information truthfully and in an understandable and nonmisleading manner. One observer complains that brokers, insurance agents, and other salespeople have developed a new vocabulary that obfuscates rather than reveals:

> Walk into a broker's office these days. You won't be sold a product. You won't even find a broker. Instead, a "financial adviser" will "help you select" an "appropriate planning vehicle," or "offer" a menu of "investment choices" or "options" among which to "allocate your money." . . . [Insurance agents] peddle such euphemisms as "private retirement accounts," "college savings plans," and "charitable remainder trusts." . . . Among other linguistic sleights of hand in common usage these days: saying tax-free when, in fact, it's only tax-deferred; high yield when it's downright risky; and projected returns when it's more likely in your dreams.[2]

Salespeople avoid speaking of commissions, even though they are the source of their remuneration. Commissions on mutual funds are "front-end" or "back-end loads"; and insurance agents, whose commission can approach 100 percent of the first year's premium, are not legally required to disclose this fact—and they rarely do. The agents of one insurance company represented life insurance policies as "retirement plans" and referred to the premiums as "deposits."[3]

Deception is a broad term without clear boundaries. The Federal Trade Commission (FTC) was charged by Congress in 1914 with the task of protecting consumers from deceptive advertising, and the Commission struggles to this day in developing an adequate definition. Federal securities law prohibits practices that would "operate as a fraud or deceit" on a person; the Investment Company Act, which regulates mutual funds, contains similar language; and state insurance laws also prohibit fraud and deception in the sale of insurance. Most legal action has focused on fraud, with the result that the concept of deception in finance lacks a clear legal definition.

Despite the vagueness of the term, some guidelines have been developed for identifying deception. In general, a person is deceived when that person holds a false belief as a result of some claim made by another. That claim may be either a false or misleading statement or a statement that is incomplete in some crucial way. Even if every claim made by Merrill Lynch brokers is literally true, deception is still possible if the clients formed mistaken beliefs because of statements made or not made. Indeed, some investors in the Arvida limited partnerships claimed that the distinction between return *on* capital and a return *of* capital was not clearly explained to them, and that, as a result, they misunderstood the cash-flow projections. In short, the investors complained that the brokers' sales pitch was deceptive.

In addition to defining deception, it is necessary to determine when it is morally objectionable and falls afoul of the law. The FTC, the SEC, and other regulators employ a three-factor test: (1) How reasonable is the person who is deceived? (2) How easily could a person avoid being deceived? (3) How significantly is the person harmed by the deception?

First, some people are more easily deceived than others, and some claims could mislead only a few, rather gullible individuals. Regulations that seek to protect even the most ignorant consumer would prohibit all but the most straightforward of claims and would severely hamper advertising and promotion. Regulators have generally employed a *reasonable person* standard that asks whether a customer or client of ordinary intelligence and knowledge would draw a mistaken conclusion from a claim. For example, advertising for credit cards and bank loans often features a low "teaser" rate that applies for an initial period. Even though the attractive rate is featured prominently in advertisements, a reasonable person, it is assumed, can read the fine print and compare the various offers. On the other hand, a misleading comparison of mutual fund performance that would lead even careful readers to conclude that a poorly performing fund is superior to the competition is arguably deceptive.

Second, potentially deceptive claims that can be easily countered by readily accessible information are less objectionable than claims that most people can accept only at face value. Information on mutual fund performance is so widely available—albeit in confusing abundance—that a single misleading comparison is not as serious as a misstatement of the fees for a particular fund, since this is information that an investor can obtain only from a company's own material.

Third, deception that would lead a person to suffer a significant financial loss or some other grave harm is of greater concern to regulators than a misleading statement that leads to a trivial loss. For this reason, claims about finance and healthcare receive more scrutiny than claims about, say, clothing or perfumes, and misleading claims for home equity loans, where a person's home is at risk, are more likely to be considered deceptive than equally misleading claims for credit cards or installment loans. False and misleading claims are morally objectionable because they are forms of dishonesty. More problematical is the concealment of information, because whether a claim is false or misleading is a matter of fact, whereas what information *ought* to be revealed involves a value judgment. Furthermore, the moral objection to concealment is not that concealing certain information is *dishonest* but that it is *unfair*. Whether a sales practice is deceptive due to concealment cannot easily be determined, therefore, without considering the conditions for fair market transactions (which are discussed in Chapter 5).

Economic exchanges are generally considered to be fair if each party makes a *rational choice*—or at least has the opportunity to make a rational choice. Consequently, sales practices in finance are unfair, and hence deceptive, when they substantially interfere with the ability of people to make rational choices about financial matters. The concept of rational choice in economics is complicated, but the details need not concern us here. It is sufficient to note that economic theory assumes that in any economic transaction each party gives up something (a cost) and receives something in return (a benefit). In addition, economic actors make choices that produce (or are expected to produce) the greatest net return for themselves. In short, economic actors are assumed to be egoistic utility maximizers.

This concept of economic rationality further presupposes that:

1. Both the buyer and the seller are capable of making a rational choice.
2. Both the buyer and the seller have sufficient information to make a rational choice.
3. Neither the buyer nor the seller is denied the opportunity to make a rational choice (this condition excludes coercion, for example).

All three of these conditions are fraught with difficulties. A misleading claim may constitute manipulation, and thus cross a line between legitimate persuasion and illegitimate coercion. But where should that line be drawn? The capacity for rational choice is an uncertain standard, not only because many people are unsophisticated about financial matters but also because even experienced investors may not understand complex transactions. This condition does not specify how people who are unable to make a rational choice should be treated. Who is responsible for protecting vulnerable investors? Should they be barred from certain markets? Should some education be required? Finally, what is sufficient information? Who has an obligation to ensure that an investor is sufficiently informed?

Examples for analysis

In order to examine some of the difficulties in the conditions for fair market exchanges that bear on whether claims are deceptive, consider the following situations:

1. A brokerage firm buys a block of stock prior to issuing a research report that contains a "buy" recommendation in order to ensure that enough

shares are available to fill customer orders. However, customers are not told that they are buying stock from the firm's own holding, and they are charged the current market price plus the standard commission for a trade even though no trade takes place.

2. A broker assures a client that an initial public offering (IPO) of a closed-end fund is sold without a commission and encourages quick action by saying that after the IPO is sold, subsequent buyers will have to pay a 7 percent commission. In fact, a 7 percent commission is built into the price of the IPO, and this charge is revealed in the prospectus but will not appear on the settlement statement for the purchase.
3. The names of some mutual funds do not accurately reflect the fund's true investment objectives. One study showed that fewer than two-thirds of the funds classified as "growth and income" performed in a manner that is consistent with that investing style. However, the investment objectives of any fund are stated in the prospectus, and the current portfolios of all active funds are available for inspection.[4]
4. Insurance companies that sell variable annuities are permitted by the SEC to advertise with charts that project hypothetical returns that do not include "mortality and expense risk" (M&E) charges for insurance coverage.[5] These charges, which range from 1.27 to 1.4 percent annually, must be disclosed in the text of all advertising. The insurance industry contends that omitting M&E charges from the hypothetical returns is necessary in order for investors to compare their variable annuities with those offered by mutual fund companies, which do not contain any insurance coverage.

First, we can ask whether the information in question would have a significant bearing on an investor's purchasing decision. That is, is the information *material*? If an investor decides to purchase shares of stock in response to a "buy" recommendation, it matters little whether the shares are bought on the open market or from a brokerage firm's holdings. The price is the same. An investor might appreciate the opportunity to share any profit that is realized by the firm (because of lower trading costs and perhaps a lower stock price before the recommendation is released), but the firm is under no obligation to share its profit with clients. To do so, moreover, would invite the charge of favoring some clients over others. (However, the practice of amassing holdings in advance of a "buy" recommendation is criticized as a form of insider trading because a firm buys stock with knowledge of a not-yet-released analysts' report.)

On the other hand, a client might be induced to buy an initial offering of a closed-end mutual fund in the mistaken belief that the purchase would avoid a commission charge. The fact that the commission charge is disclosed in the prospectus might ordinarily exonerate the broker from a charge of deception, except that the false belief is created by the broker's claim, which, at best, skirts the edge of honesty. Arguably, the broker made the claim with an intent to deceive, and a typical prudent investor is apt to feel that there was an attempt to deceive.

Second, information about the investment objective of a mutual fund is material by any reasonable standard, but has the threshold for full disclosure been achieved by statements in the prospectus? The name of a fund conveys some information, but unless the description is highly inaccurate (such as a speculative junk-bond fund called "The Widow and Orphan Secure Income Fund"), it is questionable whether investors are seriously harmed. Investment objectives are difficult to state in a name, and so it is not unreasonable to expect investors to read the prospectus for this information.

Fund-tracking firms, such as Lipper Analytical, Morningstar, and Value Line, classify mutual funds, so that some of the responsibility for any deception and part of any remedy rests with the classifying by these firms. The SEC and the National Association of Securities Dealers (NASD) examined the situation and concluded that the benefits of greater regulation for investors do not outweigh the costs, especially given the practical difficulties of devising adequate guidelines. (For example, nondescriptive fund names would deprive investors of one form of communication about investment objectives.) The debate on whether fund names are deceptive revolves around utilitarian considerations, namely the seriousness of the harm, the ease of avoidance, and the costs and benefits of the proposed remedies.

Third, the question of whether insurance companies should be permitted to use charts that omit M&E charges is debated mainly in terms of *fair competition* with mutual funds. Variable pension annuities are essentially mutual funds with tax-deferred contributions. One SEC official explained: "For purposes of understanding what the tax effect would be, you have to show the returns [of both insurance company and mutual fund variable annuities] net of all charges. It levels the playing field."[6] Critics complain that some M&E charges are ordinary fund management expenses that mutual funds must reflect in charting hypothetical returns. If so, then omitting M&E charges tilts the playing field in favor of the insurance companies. However, both sides agree on the proposition that disclosure rules should promote fair competition between variable-annuity providers and enable consumers to compare the products of these providers in easily understood presentations.

Responsibility to protect

What is the obligation of brokers, agents, or other salespersons in finance to protect the interests of those who buy financial products? Certainly, a broker, for example, should not exploit a naive or inexperienced client, but does a broker have a strong positive obligation, like that of a physician or a lawyer, to disclose fully and to act solely for the benefit of others? The responsibility of a broker to protect may not extend this far, but neither is a broker merely a salesperson. A broker may not be a shepherd protecting a flock, but the broker's role is not just to shear the sheep.

The responsibility of any salesperson can range from *caveat emptor* to *paternalism*. However, *caveat emptor* ("let the buyer beware") is not the rule of the modern marketplace because every seller is bound by a substantial body of law, including the Uniform Commercial Code, which requires "honesty in fact and the observance of reasonable commercial standards of fair dealing in trade." According to the Uniform Commercial Code, sellers also warrant that their products are of an acceptable level of quality and fit for the purpose for which they are ordinarily used. The underlying assumption is that a seller generally has superior knowledge, so that it is more cost effective to place the burden of consumer protection on sellers rather than buyers of products. If a sales clerk at a hardware store has a legal obligation to protect consumers in the sale of a wrench, then it is not unreasonable to expect at least as high a level of conduct from a broker selling limited partnerships.

However, the focus of a seller's obligations is on the product itself and on the way in which it is represented. The decision to buy is left to the buyer, and the typical seller has no obligation to ensure that the buyer makes a wise choice. An underlying assumption of the market system is that buyers are the best judge of their own interests and should be free to make their own decisions once they are fully informed. The alternative is *paternalism*, which is generally deplored as an unjustified limitation on people's freedom. However, a responsibility to protect clients—and hence some paternalism—is supported by two considerations. One is that the broker is more than a seller when he or she is serving as an adviser because an agency relationship is thereby created by a kind of contract. The other consideration is that people are generally more vulnerable in making investment decisions than in making typical consumer purchases, so that a failure to protect their interests may be regarded as abuse or unfair advantage-taking. These two considerations raise the questions: What is the nature of the relationship between a salesperson and a client or customer? What constitutes abuse?

Unfortunately, these questions are difficult to answer without examining specific cases because each one is different. Aside from the responsibility of all sellers in a buyer–seller situation, some responsibilities are imposed as a matter of market efficiency or public policy. Thus, there is concern that pushing unprepared investors into stock mutual funds endangers the market if they are not prepared to withstand a long downturn. Perhaps the main basis of the responsibility of any seller of financial products and services is the "shingle theory." Under this theory, many different relationships are possible, but any seller should be held to whatever level of responsibility he or she offers in "hanging out a shingle" and thereby opening up a business. Thus, to call oneself a broker is to create a certain expectation of competent and fair treatment.

For example, investment advisers represent themselves to clients as objective, independent consultants who will offer, for compensation, sound investment advice. Some advisers are "fee-only," which is to say that they seek to gain further client confidence by advertising that they do not accept commissions or other compensation for investments made on behalf of clients. Whether investment advisers who are not "fee-only" have an obligation to reveal commissions and other compensation is more problematical.

Churning, twisting, and flipping

The variety of abuses in the financial services industry has spawned a colorful vocabulary that is more appropriate to con artists than dedicated professionals. No one in the industry defends these practices, and firms diligently guard against them. Nevertheless, rogue employees and occasionally whole organizations are guilty of these unsavory tactics, and the record of the industry in punishing the perpetrators and compensating the victims has not been exemplary. The offending individuals often switch jobs and continue their misconduct, and firms generally fight complaints vigorously rather than settle them justly. Churning, twisting, flipping, and other abusive practices stain the reputation of the financial services industry and undermine public confidence.

Given that these practices are unethical and sometimes illegal, the main ethical questions are what constitutes churning, twisting, and so on, and what ought to be done to prevent them. Churning is wrong by definition, but there may be honest differences of opinion on whether losses in a portfolio are due to churning by the broker or to the client's own mistakes or inattention. Brokers and their firms may be victimized by disgruntled investors who seek to recover their losses by falsely charging that their accounts were churned.[7] Similar problems attend twisting and flipping. What separates these unethical practices from aggressive but ethical selling of insurance policies or consumer loans?

The ethical issues

First, some definitions. *Churning* is defined as excessive or inappropriate trading for a client's account by a broker who has control over the account, with the intent to generate commissions rather than to benefit the client. *Twisting* refers to the practice by insurance agents of persuading a policyholder to replace an older policy with a newer one that provides little if any additional benefit, but generates a commission for the agent. Typically, in twisting, the cash value of an old ordinary or straight life insurance policy is used to finance the new policy. The corresponding tactic in the consumer loan business is called *flipping*. A loan officer who "flips" a customer manages to replace an existing loan with a new one that usually provides the customer with some additional cash. Since new loans are accompanied by numerous fees, flipped loan customers may end up paying as much in fees as they receive in loan proceeds. In one case, an illiterate retiree with equity in a home was flipped 10 times in a four-year period as an original \$1250 loan grew to \$45 000.[8] The victim paid \$19 000 in loan fees for the privilege of borrowing \$23 000, so that fees constituted a whopping 83 percent of the loan proceeds.

The poor are frequent targets of other abuses by loan providers. In 1989, ITT Consumer Financial Corporation settled suits in many states for pressuring loan customers to add on various "options," including credit, property, and term life insurance and membership in the ITT Consumer Thrift Club.[9] In 1997, Sears, Roebuck & Co. was charged with unfair credit card collection practices for persuading customers whose debts had been legally wiped out by personal bankruptcy to pay the outstanding balances anyway.[10] Sears admitted that it had used "flawed legal judgment" in not filing the documents (called "reaffirmation agreements") with the bankruptcy court, as required by law.

Although churning occurs, there is disagreement on the frequency or the rate of detection. The brokerage industry contends that churning is a rare occurrence and is easily detected by firms as well as clients. No statistics are kept on churning, but complaints to the SEC and various exchanges about unauthorized trading and other abuses have risen sharply in recent years. In 1995, SEC chairman Arthur Levitt, who has been especially critical of the compensation system in the securities industry, commissioned a report on compensation practices which concluded that churning was "at the heart of many of the concerns" that the commission heard over the past year.[11] The report identified some "best practices" in the industry that might prevent churning, including ending the practice of paying a higher commission for a company's own products, prohibiting sales contests for specific products, and tying a portion of compensation to the size of a client's account, regardless of the number of transactions. Some critics of the industry cite May 1, 1975, as a major turning point in the treatment of small investors because on that day (called "Mayday" by worried brokers) the industry changed from fixed commissions to variable, negotiated commissions. The 1995 SEC report on compensation in the securities industry concluded that the commission system "is too deeply rooted" to be significantly changed and recommended better training and oversight by brokerage firms.[12]

The ethical objection to churning is straightforward. It is a breach of a fiduciary duty to trade in ways that are not in a client's best interests. Churning, as distinct from unauthorized trading, occurs only when a client turns over control of an account to a broker, and, by taking control, a broker assumes a responsibility to serve the client's interests. An insurance agent or a loan officer, like a broker who merely recommends a trade, is not acting necessarily on behalf of a client or customer and is more akin to a traditional seller. The ethical fault with twisting and flipping, then, is that they violate the ethics of the buyer–seller relationship. Typically, these practices involve deception or unfair advantage-taking or both, and they are often facilitated by building a relationship of trust that is then abused. The courts have generally refused to enforce grossly one-sided contracts by employing a test of conscionableness. An unconscionable agreement may be defined loosely as one that no person in a right frame of mind would accept and no honest person would offer.

What is churning?

Despite clear-cut instances of churning, the concept is difficult to define. Some legal definitions offered in court decisions are: "excessive trading by a broker disproportionate to the size of the account involved, in order to generate commissions,"[13] and a situation in which "brokers, exercising control over the frequency and volume of trading in the customer's account initiates transactions that are excessive in view of the character of the account."[14] Federal suits under Section 10(b) of the Securities Exchange Act of 1934 have raised the question of the need to establish that a broker traded with the intention of generating commissions rather than benefiting the client. The legal term is *scienter*, which is "a mental state embracing intent to deceive, manipulate, or defraud."[15] In *Ernst & Ernst v. Hochfelder* (1976), the Supreme Court held that *scienter* is a necessary element of churning. The legal definition of churning contains three elements: (1) the broker controls the account; (2) the trading is excessive for the character of the account; and (3) the broker acted with intent (*scienter*).

Whether a broker has control of an account or is trading at the direction of the client is often a source of dispute. A broker is not authorized to control an account and to trade without explicit directions unless the client has signed a statement giving approval. However, many brokers who have the authority to control an account still consult with the client and seek approval for specific trades. Thus, a broker may claim that the questionable trades were made with the knowledge and consent of the client. Some brokerage firms seek to cover themselves by sending "comfort" or "happiness" letters when a broker's manager notes unusual trading activity. These letters typically thank the client for doing business with the firm, express the hope that the client is satisfied, and specifically solicit suggestions for improvement. Although clients often discard these letters as junk mail, the firm may use them to show that any excessive trading was approved by the client and that the broker did not have control.

The most difficult issue in the definition of churning is the meaning of "excessive trading." First, whether trading is excessive depends on the character of the account. A client who is a more speculative investor, willing to assume higher risk for a greater return, should expect a higher trading volume. Second, high volume is not the only factor; pointless trades might be considered churning even if the volume is relatively low. Examples are "in-and-out" trading or "switching," in which one stock is replaced by another with similar characteristics, and cross trading, in which blocks of stock are transferred between two similar accounts. In addition, a broker who does not cancel a customer's call at its expiration but exercises the option and then immediately sells the stock could garner two commissions while making no change in a client's portfolio. Third, churning might be indicated by a pattern of trading that consistently favors trades that yield higher commissions. Common to these three points is the question of whether the trades make sense from an investment point of view. High-volume trading that loses money might still be defended as an intelligent but unsuccessful investment strategy, whereas investments that represent no strategy beyond generating commissions are objectionable, no matter the amount gained or lost.

Several attempts have been made to quantify excessive trading on the basis of the *annualized turnover ratio* (ATR) of a portfolio.[16] An often-cited measure is the 2–4–6 rule, whereby a turnover during any period that is proportionate to buying and selling twice the value of a portfolio during a year (ATR = 2) is considered to be possible churning. When there is a fourfold annualized turnover ratio (ATR = 4), churning is presumed, and an ATR of 6 is conclusive proof of churning. The 2–4–6 rule takes no account of the variation in turnover that is due to the character of the account. An alternative that considers this factor is a measure based on the mean annualized turnover rate of mutual funds with investment objectives that match those of the investor.[17] Specifically, the proposal is that churning occurs when the ATR is equal to the mean for the appropriate category of mutual funds plus twice the standard deviation. If aggressive growth mutual funds have a mean ATR of 0.9 and a standard deviation of 1.3, then the ATR of the portfolio of a client who wants aggressive growth should not exceed 3.5 [$ATR = 0.9 + (2 \times 1.3)$].

Neither of these quantitative measures serves to define churning.[18] First, the measures are arbitrary. Although 2–4–6 is plausible, why not 1–3–5, or any other similar sequence of numbers? Second, churning could conceivably occur when the turnover ratio is substantially less than any given figure, and not occur when the turnover ratio is substantially higher. In short, the reasonableness of the trades must be taken into account. Third, the use of any numerical measure is potentially dangerous because it might encourage commission-driven trading up to any permissible limit. At the same time, a rigid numerical measure might discourage legitimate, potentially profitable trading in a client's account for fear of being charged with churning. For these reasons, a court declared in one important case, "Churning cannot and need not be established by any one precise rule or formula."[19]

Suitability

Churning, twisting, flipping, and other abusive practices are indicated not merely by the volume of transactions but also by their suitability. A brokerage account with a high volume of suitable trades might not be considered a case of churning, whereas an account with a lower volume of unsuitable trades might be. Of course, a single recommendation, in which churning is not alleged, can also be unsuitable. In general, brokers, insurance agents, and other salespeople have an obligation to recommend only suitable securities and financial products. However, suitability, like churning, is difficult to define precisely.

The rules of the NASD include the following: "In recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holding and as to his financial situation and needs."[20] A legal suit alleging unsuitability must meet three tests: (1) the broker has made a recommendation; (2) the security in question is unsuitable; and (3) the broker has acted knowingly (with *scienter*).

The NASD rule and the legal test it contains raise several difficulties. First, when has a broker made a recommendation? After discussing an investment with a customer, a broker may believe that the customer has made a choice, despite attempts by the broker to warn the customer of risks, while the customer may believe that he or she is acting at the urging of the broker. The conversation between a broker and customer is obviously subject to misunderstanding. Second, the rule expresses an obligation to seek information from the customer about his or her financial means and objectives. However, how far should a broker probe? How can a broker be assured that the information is sufficient and accurate? The frequently offered refrain, "Know your customer," requires a broker to use due diligence in learning the essential facts about a customer. However, the standards for due diligence in this context are not always easy to determine. Third, *scienter* is difficult to prove because it involves the broker's knowledge of both the customer's financial means and objectives and the nature of the security, and the broker can claim inadequate knowledge of one or both. The recommendation of an unsuitable security can be made out of incompetence or negligence rather than with fraudulent intent, and the distinction between the two types of cases may be difficult to draw. However, reckless conduct in which a competent broker should know that the security is unsuitable is often sufficient to establish *scienter*.

Of course, the most difficult question is: When is a security unsuitable? Rarely is a single security unsuitable except in the context of an investor's total portfolio. Investments are most often deemed to be unsuitable because they involve excessive risk, but a few risky investments may be appropriate in a well-balanced, generally conservative portfolio. Furthermore, even an aggressive, risk-taking portfolio may include unsuitable securities if the risk is not compensated by the expected return.

Modern portfolio theory provides a suitability test for portfolios by means of the concept of the *efficient frontier*.[21] The efficient frontier is a curve on a graph that plots portfolios with the maximum return for each level of risk. Possible portfolios far from the frontier consist of demonstrably unsuitable securities because an investor could gain a higher return for the same risk or assume less risk for the same return. A portfolio at or near the frontier contains unsuitable securities only if the degree of risk is not that desired by the investor. In that case, suitability can be achieved by moving up or down the curve that marks the efficient frontier. Securities are unsuitable, then, when the risk is excessive with respect either to the preferences of the investor or to the expected return.

The most common causes of unsuitability are: (1) *unsuitable types of securities*—recommending stocks, for example, when bonds would better fit the investor's objectives; (2) *unsuitable grades of securities*, such as selecting lower rated bonds when higher-rated ones are more appropriate; (3) *unsuitable diversification*, which leaves the portfolio vulnerable to changes in the markets; (4) *unsuitable trading techniques*, including the use of margin or options, which can leverage an account and create greater volatility and risk; and (5) *unsuitable liquidity*, which involves the ease with which a security can be sold or liquidated. Limited partnerships, for example, are not very marketable and are thus unsuitable for customers who may need funds soon.

Ensuring that a recommended security is suitable for a given investor involves many factors, but people in the financial services industry offer to put their specialized knowledge and skills to work for us. We expect suitable recommendations from physicians, lawyers, and accountants. Why should we expect anything less from finance professionals?

Credit Cards

Credit cards are greatly valued by both users and issuers.[22] For the millions who use them, these ubiquitous pieces of plastic are not only a convenient form of payment but also a ready source of credit—for purchases both planned and spontaneous, essential and frivolous. The issuing banks also depend heavily on credit cards—and their cousin, debit cards—as carefully cultivated sources of revenue. When a customer presents either kind of card for a purchase, the selling business pays a "swipe fee" that compensates the issuer for its services. When users of credit cards allow balances to develop, they pay interest at very high rates, and when payments are late, credit limits are exceeded or overdrafts occur, cardholders are charged very hefty fees, which greatly enrich the issuers.

The value of credit cards to users is demonstrated by the extent of cardholder reliance on them. In 2012, 68 percent of US households possessed at least one card, and although 40 percent of these cardholders carried no revolving balance, the total indebtedness on credit cards of the remaining 60 percent was $854 billion.[23] (This amount is down from a peak of more than $1 trillion in 2007–2008.) Moreover, 40 percent of cardholders use this form of debt to finance basic living expenses because they lack sufficient funds in checking and savings accounts.[24] The average credit card debt for this low- and middle-income group in 2012 was slightly over $7000, the main contributors to their debt load being unemployment and medical bills. Without access to credit card debt, these credit-reliant households would suffer deprivation or else be forced to turn to payday loans and other, more onerous forms of debt. Millions of people depend on a plastic safety net.

Although reliable figures on the profitability of credit cards for issuers are not available, one estimate is that the total earnings of the industry in 2011 were $18.5 billion, which is an increase over the $13.6 billion earned in 2010.[25] This increase occurred despite predictions that profitability would fall in the wake of the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (CARD Act), which contained many needed reforms.[26] The magnitude of issuer profits is also reflected in the 2012 annual report by the Federal Reserve on the profitability of credit card operations. According to this report, the return on assets for large credit card banks was 5.37 percent, while the return for all commercial banks was only 1.18 percent.[27] The difference between these two figures dramatically illustrates the value of credit cards for the issuers' bottom lines.

The reliance of users on cards and the dependency of issuers on the profits they generate create many opportunities and incentives for abuse. Needy users can be subjected to high rates and fees without much resistance or fear of competitors with lower costs, while issuers search aggressively for creative new ways to increase revenue within the limits set by the evolving law. The mindset of the issuers was described by one former CEO of a credit card company in a candid interview: "Bankers will figure it out to comply and say, 'As long as I'm in compliance with what the government says, it's none of anybody's business to tell me what to do'. . . . Yeah, I mean, because you guys are none of you smart enough. You make the stupid laws, I'll comply and I'll make money."[28]

The pricing strategies of credit card issuers take advantage of consumers' inattention to certain matters, lack of financial knowledge, limited ability to understand, and well-known behavioral biases, such as excessive optimism about their ability to repay.[29] In addition to the direct losses incurred by credit card users from excessive rates and fees and the significant human costs of heavy indebtedness, inefficient pricing imposes a burden on the whole economy when the amounts paid are not proportional to the actual costs of extending credit and assuming risk. From an economic point of view, distorted prices impede the operation of market mechanisms, which has the effect, in the case of credit cards, of leading consumers to underestimate the cost of credit—and, hence, perhaps, to engage in overconsumption—and of causing banks to misallocate credit and mismanage risk. Ethical concerns about credit cards are not confined to the possible abuse of users but extend to the health of the economy at large. When credit card abuse occurs, everyone suffers, the banks included.

Ethical concerns

Ethical concerns with credit cards, as well as debit cards, are unusually broad. First, as with any financial product, these cards should be made available to consumers with full, accurate disclosure of relevant information without deception, concealment, or guile. Whatever the terms—in this case about interest rates, service or penalty fees, payment requirements, liability for unauthorized use, resolution of disputes, notification of changes, and the like—they should be clearly disclosed in ways that can be easily known and understood by card applicants. The ethical principle at issue is *transparency*.

Because of legal requirements for issuing cards, as well as legal protections for issuers, all necessary details are usually expressed fully in the standard credit or debit card contract. The main problem is readability: the ability of consumers to fully understand the terms—indeed, to have even a rudimentary understanding—is impeded by the use of incomprehensible legal language, often in small, faint type. The average American reads at a ninth-grade level, while the typical credit card agreement is written on a twelfth-grade reading level, thereby making it inaccessible to four out of five adults.[30] This lack of readability is probably no accident: card issuers certainly benefit from befuddled, ignorant consumers. However, the industry replies that both the legal wording and the extensive content of agreements are necessary to comply with the law. However, the US Consumer Financial Products Bureau has developed a two-page form in accessible language that it believes is adequate. In any event, a simple explanation of terms could always be provided to applicants in addition to the formal agreement.

In addition to ensuring that the terms of a card agreement are transparent—that is, clearly known and understood—a second requirement is that the terms be *fair*. Although fairness is unexceptional as a general requirement, it is problematic in application for many reasons. For one, the terms of credit card agreements address many different matters, including rates and fees, payments, dispute resolution, notification of changes, and the like. What is a fair interest rate is obviously different from the fairness of a late-payment fee or the resolution of a billing error. Second, fairness itself may be judged in different ways. In particular, a distinction is commonly made between fairness in process or procedure and fairness in outcome or substance. A fair process may produce an unfair outcome, and vice versa, and standards for a fair process and a fair outcome may differ.

The typical credit or debit card agreement raises questions of fair process since they are presented to the applicant on a take-it-or-leave-it basis, with little difference between issuers. (In legal terms, these are *contracts of adhesion*.) Because of an imbalance of power and some collusion among issuers, an applicant has virtually no opportunity to bargain or seek better terms elsewhere. Hence, they cannot be said to have consented to the terms of a card agreement in any meaningful sense. Put another way, the card industry falls short of an ideal free market since one party, the buyer in this case, has few options and the sellers refuse to compete by offering more attractive terms. Under such conditions, one virtue of markets—that their outcomes are justified by consent—is not fully realized. Even if applicants fully understand a card agreement, its terms are unlikely to be the ones they would prefer, nor the ones they could likely obtain in a perfectly free market.

Issues of fairness of the terms in card agreements arise mainly in the area of outcome or substance, especially about interest rates and fees. Not only are very high interest rates often charged, but the methods for calculating them are unduly complicated and easily manipulated for the issuer's gain. For example, different portions of a cardholder's balance often have different interest rates, and payments may be credited first to reduce the amount owed on portions that carry the lowest interest rate regardless of when this balance was incurred. This method of crediting payments obviously benefits the issuer at the expense of the user. Is this fair? Also, issuers have been accused of setting rules for fees in ways that trigger them more often and increase the total amounts owed. Are such rules fair?

A third factor that raises ethical concerns about credit and debit cards is their impact on *social welfare*. The marketing of credit cards to people who cannot handle debt responsibly may lead to individual health problems, such as anxiety and depression, to family discord resulting in divorce and child neglect, and to lifelong financial instability from impaired credit history and lack of savings. Special attention has been directed to credit card marketing to students, whose irresponsible use may cause them to leave school or hamper them for years to come. More broadly, the vast expansion of consumer credit that cards have facilitated has profound consequences for how people spend, save, and invest and how the economy and society grow and develop.[31]

Of the numerous ethical concerns with credit and debit cards related to transparency, fairness, and social welfare, two of the most controversial ones are examined in the remainder of this section, namely the marketing of credit cards to students and the rates and fees associated with cards.

Marketing to students

An all-too-familiar phase of many students' college experience is the initial euphoria of acquiring that first credit card, soon followed by overwhelming feelings of hopelessness and desperation as debts mount and the demands for repayment become more insistent. Irresponsible credit card use by students is known to impair academic performance from anxiety and, for many, from longer hours spent working. The resulting indebtedness may also have destructive life-long consequences when students are forced to drop out of school or find it difficult, upon graduation, to rent or buy housing or to obtain a desired job because of a damaged credit record. Schools suffer as well when they lose students to credit card debt, and the loss to society from the failure of students to complete their education or participate fully in the economy is also substantial. The human cost of marketing credit cards to students is a problem of social welfare that has drawn a considerable amount of attention from the general public, as well as government.

Balanced against this undeniable problem of social welfare are the convenience of credit cards for payments and the benefit of access to credit, especially in emergency situations. In addition, the vast majority of students who handle cards responsibility not only acquire useful financial management skills in college but also begin to develop a credit history, which is essential for adult life. Furthermore, students over the age of 18 are legally adults, and many of them, as well as most college-age youth who are not in school, are financially independent of their parents and have as much need for credit as anyone else in society. Is it fair that students should be deprived of the use of credit cards merely because they are in school? Or is it fair that nonstudents of college age should be deprived of credit in order to protect those still in school? These are questions of fairness.

The ethical concerns over the marketing of credit cards to students are directed mainly at credit card issuers, who solicit applications from students, approve students for credit cards, and service their credit card accounts. However, the marketing is often done on campuses, typically in accord with some agreement with the college or university. These agreements usually commit the school to provide space for on-campus solicitation and also disclose names and addresses for direct mailings. Issuers further benefit from the school connection when students believe—mistakenly in most instances—that the card companies on campus have been screened for reliability. In return for their services, the schools receive some compensation, which, for some, amount to a not insignificant source of revenue. Critics allege that colleges and universities not only fail to protect the young people in their charge but are profiting from the harm that is done. So the marketing of credit cards to students also brings into question the responsibility of the schools that facilitate, and perhaps even benefit from, the problems of indebtedness. However, students themselves and, to some extent, their parents also bear some responsibility.

The main abuses in the marketing of credit cards to students and others of college age were addressed in the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 in Title III—Protection of Young Consumers.[32] The unethical practices that were commonplace before the passage of the CARD Act can be described, but they may no longer raise ethical concerns if, indeed, this legislation succeeds in its aims. These practices are still worth examining, however, in order to understand what constitutes responsible marketing in this case, as well as to assess the adequacy of the CARD Act itself. That is, does this act accurately reflect the ethical principles that should guide the marketing of credit cards to students? Also, does it effectively implement these principles?

Two areas in which credit card issuers have been criticized with regard to ethics are the extension of credit to young people with questionable ability to make payments and the marketing of cards on campus by such means as prescreened mail offers and gifts for making an application. These questionable means have been facilitated by agreements between the credit card companies and colleges and universities, which have also received criticism.

Assessing creditworthiness

Since most students study full time or hold part-time jobs at best, they are unlikely to have sufficient income to support payments on any significant credit card balance. For this reason, college students as a group would not seem to be a promising target market for credit cards, and, certainly, credit card applications should be approved for students only with a careful assessment of their creditworthiness. Applications from students should be held, at least, to the same standards of creditworthiness as those of older adults, if not higher ones. The information submitted should be verified with the same rigor, and the initial credit limits should also be determined by the same criteria. Unfortunately, these commonsense prescriptions have been widely disregarded by credit card companies in the stiff competition for student customers.

The college student market is attractive for issuers because it is largely untapped, and it is restocked each year with new entering classes. Credit card users tend to show great loyalty, so the first card received will often lead to life-long use, along with future business for the issuing company. The long-term value of a student customer is perhaps greater than the revenue gained in the short run—which may still be substantial. Although significant losses occur in this market, especially when debts must be written off because they are uncollectable or discharged in bankruptcy, the fees and interest that student users incur still make the business profitable for the issuers. Moreover, students without income are not without money, and they spend it quite liberally. Allowances from parents are typical, and parents often stand ready to make up shortfalls and may be induced to pay their children's debts, even when they are not legally required to do so. In this way, parents become *de facto* co-signers. For all these reasons, credit card companies have strong incentives to target this market aggressively and to extend credit without strong, verified evidence of ability to pay.

The ability of credit card companies to verify information is limited, even if they make the effort, and students who are eager to obtain a card can often do so by subterfuge. Applicants sometimes list scholarship and student loan funds as income and even use them to pay credit card bills. Issuers are often unaware that applicants possess several credit cards, which may already have high balances, although a cursory credit check might reveal such facts. The ability to pay is relative not only to income but also to the amount owed, and an applicant may be judged capable of handling a small credit line but not the large balance that is actually owed. Once cards are acquired, users can disguise payment problems by using an advance on one card to make a minimum payment on another, so that an issuer may be unaware when a user is having difficulty making payments. A good payment history by such means may lead the issuer to raise the credit limit, often without being requested, which could compound the user's problems with payments.

In the typical loan process, it is unnecessary to insist that the lender assess the creditworthiness of the borrower. Since the lender bears the preponderance of the risk—which is mainly that of default—it is generally in the lender's interest to ensure that a borrower does not become overly indebted. Without any urging, a lender is likely to set standards for the ability to repay that are higher than those needed to protect the borrower. Consequently, the harm to the borrower ordinarily need not be considered by the lender since the borrower is automatically protected by the lender's caution. Credit cards generally and student users in particular constitute exceptions to this usual state of affairs. (Payday loans are another.) Under such conditions, the incentives have changed. It is now in the lender's interest to permit a borrower to assume more debt than is prudent.

This analysis of the situation raises the questions, first, of whether any wrong is being done and, second, what, if anything, should be done to correct the wrong. One answer to the first question is, yes, a wrong is done if a failure to assess creditworthiness in extending credit to college students has the impacts that are commonly claimed. The wrongness in this case is little different from the problem of defective products that injure consumers or pollution that damages the environment. The ethical principle is the prevention of harm. However, the harm in any case needs to be balanced against the benefits, which, in the case of credit card use by college students, are substantial. The marketing of credit cards has the additional element of unfair advantage-taking of a vulnerable population that stands in need of protection. Although 18-year-olds are legally adults, their financial illiteracy and impulsive financial behavior are well documented.[33] If this group is, indeed, vulnerable to unfair advantage-taking, then it should be protected in some way.

The judgment of the US Congress in passing the CARD Act was that the harm is great enough and young people are sufficiently vulnerable to warrant legislative protection. The main means Congress chose for providing this protection is a prohibition on issuing credit cards to anyone under the age of 21 without a parent or other responsible adult as a co-signer. However, an exception is provided for anyone who can demonstrate "an independent means of repaying any obligation arising from the proposed extension of credit." Obviously, what counts as an "independent" means of repayment is critical, and no assessment is required of the reliability of any source of income, so that a temporary job might be sufficient. More importantly, if the "obligation" in question is to make merely the minimum payment, then an applicant need not have enough income to pay the full balance and could, over time, acquire considerable unpayable debts.[34]

Marketing on campus

According to one observer, credit card companies "swoop down every fall on American college campuses, looking for freshman or 'fresh meat.'" This account continues, "In a 'carnival atmosphere' of blaring music and free food, the credit card companies set up tables spread with glossy promotional brochures and loaded with free t-shirts, frisbees, and other gifts to lure students into applying for credit cards."[35]

The tables are only the beginning of an assault. Applications are stuffed into bookstore bags, hung on bulletin boards, and mailed to campus addresses. Entering freshmen have reported receiving an average of eight credit card applications in the first week alone.[36] In one sample, 69 percent of students reported receiving at least one credit card offer in the mail during the past week,[37] and other studies found that students had received between 25 and 50 solicitations a semester.[38] Schools are complicit not only by allowing representatives on campus but also by providing names and addresses for mailings. The agreements between credit card companies and colleges and universities often give exclusive rights in return for payments.

Some critics charge that this aggressive marketing is *deceptive* since the representatives at tables and the materials distributed stress the benefits of credit card use but not the burdens of carrying the debt and the harm from overindebtedness. The kind of information commonly presented in card agreements is usually lacking in promotional materials. Campus representatives are usually independent contractors, who have strong incentives to sign up students with regard to the means used, and the credit card companies are often lax is monitoring their activities. Issuers also rely on students' lack of knowledge about credit card use, inattention to available information, and, about some matters, false beliefs. Although credit card marketing may not involve false or misleading information—which are the usual elements of deception—students cannot always be said to make informed decisions, and neither the issuers nor the schools do much to enable better decision making. Whether students are actually deceived by aggressive marketing, the result is often the same.

The more common objection is that students are victims of *manipulation* insofar as the sheer volume of prescreened mail offers combined with the excitement of a "carnival atmosphere" and the enticement of free gifts may prove irresistible—at least to some students. One study concluded: "The majority of college students who own credit cards do not actively seek them out, but are aggressively pursued through the mail and on-campus by credit card issuers."[39] In addition, research shows that students who are financially at risk, including those who carry larger debts relative to income, are more likely than others to obtain credit cards on campus from a table or through a mail solicitation.[40] The manipulation in credit card marketing might not be objectionable in itself, though, but for the high level of indebtedness that results from it.

The colleges and universities that permit solicitation on campus are open to criticism not only for failing to protect students from the perils of credit cards but also for profiting from the harm that is done. Robert Manning blames the emphasis on revenue generation over educational concerns to explain the willingness of school administrators "to sacrifice the long-term interests of their students and their institutions for the short-term financial inducements of the credit card industry."[41] Given the amount of revenue that schools receive from students' credit card use, they now have a vested interest in increasing students' debt load.[42] This interest creates a conflict of interest in policy decision making insofar as schools have a duty to protect the students in their care.

The CARD Act addresses these ethical problems with the marketing of credit cards on campus by various means. The most direct remedy for unsolicited prescreened credit card offers would be to legally prohibit them to people under the age of 21. However, the CARD Act approaches the problem indirectly by prohibiting credit bureaus from providing names and addresses of college-age persons without their consent. This measure restricts a critical source of information for credit card issuers, but it still allows them to mail offers if they can obtain names and addresses in other ways or obtain consent. With this restriction, the willingness of schools to provide this information becomes more significant.

Issuers are also prohibited by the CARD Act from offering any "tangible item" on or near campus to any student, regardless of age, in return for completing a credit card application. This restriction is undermined, however, by exceptions that permit gifts without requiring a completed application—free pizza may be offered to anyone passing a table, for example—and that allow nontangible rewards, such as discounts on purchases or promotional credit terms. Further, the CARD Act requires that all agreements between schools and credit card companies be disclosed to the public. This provision assumes that no college or university would sacrifice the welfare of students for the sake of a monetary benefit if this became known. This rationale follows the adage "Sunlight is the best disinfectant." However, an examination of the disclosures that have been made pursuant to this act indicate that initial fears about the amount of money received by schools and the business generated for issuers had been overestimated. Although some agreements are highly lucrative for a select few schools, the median payment reported is less than $6000, and 87 percent of the agreements generated less than 100 new credit cards accounts.[43]

Rates and fees

On August 25, 2009, Jessica Duval used her Citizens Bank debit card for a $178.20 purchase from JCS Fashion. Since two purchases earlier that day totaling $139.05 would have reduced her beginning balance of $229.68 to $90.63, the last purchase of the day would have produced an overdraft with an accompanying $39 fee.[44] However, the bank followed its standard practice of debiting the largest amount first, regardless of the chronological order of card use, with the result that the two earlier purchases each triggered a separate overdraft fee. So Ms Duval paid $78 in fees for the privilege of spending $87.57 more than she held in her account that day.

If Ms Duval had read the Deposit Agreement carefully, she would have noted that Citizens Bank reserved the right to record transactions "in any order determined by us." That wording did not reveal, though, that the bank's computers were programed to enter transactions so as to maximize the number of overdrafts. Thus, transactions were *always* entered from the highest amount to the lowest in order to multiply the number of fees—and hence maximize the bank's revenues. Transactions were sometimes withheld for days so that they could be processed in a batch, further increasing the number of overdrafts. The provision in the agreement permitting this practice was inconsistent with one, six paragraphs before, which stated, "We will not permit withdrawals from your account unless there are sufficient funds in your account." However, the Deposit Agreement also provided for automatic overdraft protection with no mention of any possibility of opting out. In effect, users got overdraft protection whether they wanted it or not—or were even aware of it. In addition, the schedule of overdraft fees was contained only in a separate pamphlet, which was not signed by the cardholder.

A class action lawsuit with Jessica Duval as the lead plaintiff resulted in a $137.5 million settlement, and some of the abusive fee-generating practices engaged in by Citizens Bank are now illegal under the CARD Act.[45] In particular, holders of debit cards in the US must now explicitly accept overdraft protection under an opt-in system rather than a system that requires them to opt out if they do not want the bank to cover transactions in accounts with insufficient funds. Still, ethical questions remain about the ways in which issuers treat card users in a wide range of matters, including not only the numbers and amounts of the rates and fees themselves but also the factors that determine them and the manner in which they are imposed and disclosed. The possibilities for generating revenue from cards are enormous, and issuers devote considerable effort and ingenuity in exploiting these possibilities.

Some practices may be criticized as deceptive, due to false, misleading, or inadequate disclosure. In this respect, abuses with debit and credit cards are little different from ethically objectionable practices with other financial products that have the potential to harm consumers. Other practices, however, may be considered ethically unacceptable even if they are completely and truthfully disclosed to, and even known and accepted by, users. The processing of debit card transactions from highest to lowest may be an example since it is contrary to reasonable expectations and seems to be designed solely to maximize the revenue from overdraft fees with little or no benefit to users. This is, arguably, something a bank ought not to do even if the card user knowingly consents, especially given that users have little choice since agreements are offered on a take-it-or-leave-it basis with little difference among issuers. Another example is that for centuries limits on rates of interests have been imposed by both ethics and law in the belief that charging excessively high rates—called *usury*—is morally wrong and ought to be legally forbidden. The wrongness persists even if a borrower is willing to accept a usurious loan.

The ethical issues with rates and fees, deception aside, fall into two categories. First are questions about whether card users are being treated *fairly* by the various actions that issuers take in their aggressive efforts to maximize revenues. Can users be said to be *abused* by certain practices even when banks act within the rights accorded by the agreements users sign? Second, certain practices may be criticized for their impact on *social welfare*, which may extend beyond the well-being of individual users to the whole of society. This impact includes the deadweight loss to the economy that occurs not only when people waste precious income on unnecessary fees and additional interest payments but also when the cost of credit is unnecessarily high. For reasons of economic efficiency, prices should reflect that actual costs to the issuers of extending credit and servicing card use, which include compensation for the risks taken as well as ordinary expenses. When economic goods are mispriced in a market, the resulting inefficiency imposes a cost that is borne by everyone in society. Virtually all questionable practices with respect to debit and credit cards raise both kind of issues—of fairness and social welfare. Since these practices are numerous, the following discussion focuses only on what constitutes fairness in card servicing and on whether interest rates should be restricted in an effort to prevent usury.

Fairness with cards

There are many ways in which card issuers could protect users and even benefit them—if they choose to do so. However, as with all products and services, the ethical obligations of sellers are limited, and consumers bear some responsibility for protecting themselves and deciding what to buy. Consumer beware—that is, *caveat emptor*—should not be the rule of the marketplace, but neither should the other extreme of seller beware, *caveat venditor*. Finding an ethical division of responsibility is a difficult but necessary task.

Issuers could help debit card users, for example, by notifying them when a transaction would cause an overdraft. Most swipes of a card are transmitted instantly to the issuing bank, and when accounts without overdraft protection have insufficient funds, the transaction is usually denied at the point of sale. In the same manner, users with this protection could easily be notified that a purchase being made will cause an overdraft. This notification would allow the user the option of paying in some other way, deciding against the purchase or incurring the fee willingly. In helping users in this way, however, banks would forgo the revenue that inadvertent overdrafts create. Another example with credit cards is that different portions of the total balance owed are often subject to different interest rates. In such cases, payments are invariably credited to portions of the balance with the lowest rate without regard for when the debts were incurred, leaving the portions with higher rates to continue earning interest for the issuer.

Other examples of practice that are not addressed by the CARD Act and continue to persist include charging an inactivity fee for customers who do not use a card within a certain period of time, and levying a minimum finance charge when a lesser amount is technically due.[46] The calculation of variable interest rates is generally complex and opaque, and although rates can rise from the initial one, that rate often constitutes a floor below which the variable rate cannot drop. New fees are imposed or old ones are increased for balance transfers, cash advances, and other transactions that were formerly free or low cost. Although issuers may prominently display a low late-payment fee, the actual amount charged may vary by the size of the balance (called "tiered late fees"), with the largest fee applied to more common low balances. This method enables the issuer to gain the benefit from the prominent display of a low fee, while increasing revenue by actually employing higher ones on the majority of balances.

These examples are but a few of the many that could be cited. What is ethically objectionable about these examples if the practices are disclosed and the user agrees to them? The adequacy of the disclosure may be questioned when the terms appear in faint, small print near the end of a long agreement that is full of dense legal language. The typical agreement seems designed to hide more than it reveals. For starters, the issuer holds most of the power in the buyer–seller relationship, which enables it to dictate the terms with no possibility of negotiation except for the refusal to sign. Such contracts of adhesion are ethically problematic insofar as they permit the imposition of highly favorable terms for the stronger party. Are there reasons to believe, though, that issuers have exploited their superior position to impose highly favorable terms for themselves?

First, many of the terms in card agreements seem designed merely to maximize revenue with little or no benefit to users. Banks have argued that processing the largest transaction on a debit card first is a benefit since it is likely to be a more important one—a rent payment, for example—that a user would want honored. However, this order for processing transactions is of benefit only to users without overdraft protection because all transactions of a protected user will be approved anyway. All that a user with overdraft protection receives is more fees. If this method of processing really is of benefit to a user, then they might well choose to opt in when opting out is the default option (which provides greater consumer protection). Late fees also benefit users by providing an incentive for prompt payment, but this beneficial motivating effect could be achieved without such complications as a tiered schedule, which makes estimation of costs virtually impossible and serves mainly to mislead. In general, the more that card agreement terms provide genuine benefits to users, the less issuers can be said to abuse their superior position.

Second, card agreements and monthly statements seem designed to increase the difficulty with which users can protect themselves and make the best use of this important payment and credit system. Protection involves not only avoidance of higher interest rates and more frequent fees but also an ability to accurately estimate costs in advance. Even if users bear a large share of the responsibility for protecting themselves, the task should not be made unnecessarily difficult, especially when alternatives are readily available. The main alternative in this case would be a simplified interest rate and fee structure that could be easily understood by a typical user. Such a structure could be easily developed by an issuer to satisfy its legitimate needs to generate sufficient revenues to cover its costs, which include compensation for risk. It would not, however, enable an issuer to realize outsized returns from cards, which brings into question the extent of its "legitimate needs."

Third, the various practices of card issuers take advantage of—some might say *exploit*—the vulnerabilities of human psychology. People are apt to pay less attention to a number of small fees rather than one big one, even when the total amounts are the same. Hence the multiplicity of small fees. People's attention is limited and is drawn more to some matters than others. Complexity in the determination of interest rates, for example, is less likely not only to be understood but also even to attract attention in the first place because of the complexity. The minimum payment option on a credit card statement involves subtle psychological considerations. The prominent placement reminds users that they need make only this minimum payment and provides a certain amount of respectability. It sends the message, "Paying only the minimum is okay." Also, the amount listed (which is typically quite modest) provides what psychologists call an "anchor" from which to decide how much to pay. Studies show that the minimum repayment amount has a causal effect on the amounts actually paid: the lower the stated minimum payment the less people pay.[47]

Fourth, when rates and fees bear little relation to an issuer's actual costs, an expectation of *reasonableness* is violated. A user should expect to pay an overdraft fee since a bank is, in effect, making a small loan, which involves administrative costs as well as the right for a certain return. However, one study found overdraft fees ranged from $10 to $38, with the median being $27.[48] A card user who is charged a $27 fee on an overdraft of $20 and who repays the amount loaned within two weeks would incur an annual interest rate of 3520 percent. This does not fit easily into any definition of reasonable.

The power of expectations of reasonableness was vividly displayed when outraged customers forced Bank of America in 2011 to rescind an announced $5 per month fee on debit cards.[49] This outrage occurred despite the fact that the fee was intended merely to recover revenue that was lost due to changes in the law, which removed charges that customers had long been paying. Not only is a $5 per month fee for debit cards similar to the annual fee charged for many credit cards but debit card users would not be paying any more in total fees than before. So understood, the proposed $5 charge is, arguably, not unreasonable. However, it touched a nerve with customers that forced the bank to abandon this plan—probably to find other sources of revenue that would be less noticeable and disturbing.

Capping rates

Laws that impose a cap or a maximum rate on the interest that can be charged for credit card and other consumer debt have long been present in most countries of the world, and proposals for yet more stringent rate ceilings are occasionally advanced in the US and elsewhere, though usually without much success. Not only is limiting interest rates a popular idea today, but the practice of even charging interest on money lent has been considered morally suspect throughout history in virtually all cultures and religions. Under the label of *usury*, charging interest on loans was condemned in ancient Greece by Plato and Aristotle; in Judaism, usury is forbidden in the five books of the Torah, which are attributed to Moses; and Thomas Aquinas provided authority for the opposition to usury in the medieval Catholic Church.[50] Some of the earliest prohibitions on usury occurred in Vedic texts and Buddhist teachings originating in India, and Islamic thought firmly condemns usury to the present day.

Absolute prohibitions on charging any interest have abated in modern times with the rise of capitalism, which recognizes the importance of capital formation in economic growth, as well as the necessity of credit in a consumer economy. Some historians attribute this critical transition to the Protestant Reformation.[51] Today, usury is commonly regarded as charging excessive or exorbitant interest. Thus, charging interest is in itself morally acceptable—this is not usury in present-day usage—but to avoid the charge of usury, the rate should be kept below some ceiling. Determining an acceptable, nonusurious rate of interest is difficult, but the arguments for capping interest at some rate closely resemble the traditional objections to charging any interest at all. The arguments against capping interest rates on credit cards or any consumer debt consist not only of responses to traditional objections but also of appeals to more contemporary economic-based considerations.

Despite the near-universal existence of laws limiting interest rates, they have little effect on the actual interest rates charged today due to the high rate levels that are legally permitted and the many means of evasion that are available. In the United States, where interest rate regulation is currently the province of the states, the ability of states to cap rates for credit cards was virtually eliminated by a 1978 court decision. The decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp*. (known as "Marquette") essentially deregulated credit card interest rates by permitting issuers to charge the highest rate permitted in its home state without regard for the laws of the state where the customer resides.[52] Not surprising, credit card companies are now located in states with little or no interest rate regulation, and these states compete with each other to offer an attractive home. Another court decision declared that late fees are a kind of interest, so these also enjoy the same favored treatment.[53] The ineffectiveness of state interest rate regulation has prompted initiatives for uniform national regulation in the US, but they have had little effect to date.

Arguments for caps. In ancient times, the argument against usury as any lending of money with interest was based, in part, on a narrow view of money as merely a medium of exchange that is an alternative to bartering, in which goods are exchanged for other goods. If money is essentially "sterile," as Aristotle claimed, then to make money off money is an unnatural act that is contrary to the natural use of money. Lending money with interest is not productive commerce, like trading goods for other goods or for money, but it is rather unearned income, more akin to the gain of thieves and pimps, whose activities add nothing of value. This view gained plausibility from the fact that money lending at the time was a nefarious activity conducted out of the public eye.

Although this argument, based on a conception of the natural use of money, was influential into medieval times, the main argument, which was central to the condemnation of usury in Judaism, Islam, and other traditions, is that lending money with interest involves an exploitation of those who are economically weak by the economically strong. Not only does this kind of unfair advantage-taking harm the poor, but it also unjustly enriches the well-to-do and further increases inequality in society. In the process, usury corrupts the lender by encouraging the vice of greed or avarice and discouraging the virtue of charity. This point is especially prominent in Islam, which places a high value on aiding to the poor: a person in need should be given money without any reciprocal obligation. Usury (or *riba* in Arabic) thus undermines the very basis of a society built on benevolence and selflessness that is central to Islam.

In sum, the traditional argument is threefold: (1) interest is unearned income that involves no productive activity; (2) interest involves the exploitation of the needy and encourages greed or avarice; and (3) interest produces socially undesirable outcomes by transferring wealth from the poor to the rich and thereby increasing inequality. The first of these objections no longer has force, since the ancients were unaware of the productive power of money in investment, as well as the role of interest as compensation for the risk taken by a lender and for the loss of opportunity to use money in other ways (which, in finance theory, is the time value of money). However, the remaining two points are of legitimate ethical concern. Exploitation and inequality ought to be addressed in any just society.[54]

In addressing these two ethical concerns, two questions must be answered. First, what level of exploitation and inequality are morally unacceptable? Exploitation, in particular, is a morally freighted concept that implies unfair advantage-taking, but it is unclear whether a lender, in charging interest, is taking advantage at all, and, if so, when—at what level of interest—the advantage-taking becomes unfair. This question is especially difficult when a borrower willingly accepts a loan at a high rate of interest. Any prohibition, either ethical or legal, might seem to constitute a form of paternalism that seeks to protect people from their own bad judgment. Inequality is generally accepted as a consequence of a market economy, and it is a phenomenon that has many causes, with high interest rates a minor one at best. So the issues of how much inequality ought to be tolerated and how much of it is caused by high interest rates remain controversial.

Second, even if high interest rates involve exploitation and produce (some) inequality, the question remains: Is capping interest rates the best way of addressing these ethical concerns? More generally, are prohibitions on usury, either ethical or legal, effective means for preventing exploitation and reducing inequality? Given the justification for lending with interest at reasonable rates, attempts to identify the level at which rates become unreasonable and to enforce the resulting limits are justifiable only if better means are not available. This is especially true if laws capping interest rates have economic costs, which is claimed in the arguments against such legislation. A similar question can be raised about executive compensation, which many consider excessive. Attempts to place legal caps on CEO pay have proven to be not only ineffective but also counterproductive,[55] and some have argued that more transparency and shareholder voice might provide better means for addressing this matter. Perhaps the same is true of high credit card interest rates.

Arguments against caps. Opponents of proposals for caps on credit card interest rates offer three arguments. First, rates for credit of all kinds are set by a competitive market in ways that reflect the costs to the lender, and so high rates are justified because they merely reflect high costs. Credit card interest is high due to the risk of default to unsecured borrowers (who, in many cases, have been extended credit without adequate assessment of creditworthiness). The costs of extending and servicing short-term loans for small amounts are also high (although these costs are also covered by charges to retailers who accept credit cards and by fees for late payment and exceeding credit limits). If the interest charged by issuers were not justified by the costs, competitors would surely step in and take business away from those with exorbitant rates—or so the argument goes.

Second, this appeal to the virtues of a market in setting a price for credit is further enhanced by the idea of free choice. Consumers willingly accept high interest rates in return for access to convenient credit. For them, the high interest of credit card debt must still represent a good value. As long as both issuers and users find this arrangement acceptable, why should the law intervene to prevent a mutually agreed-upon transaction? Doing so would constitute a form of paternalism designed to protect people from harm caused by their own actions.

Third, caps on interest rates are likely to impact the welfare of credit card users, with the heaviest toll on those who are already disadvantaged. If the legally permissible interest rates reduce the revenue from credit cards below their costs or below the return from other investments, then issuers will respond by increasing revenues, cutting costs or shifting investments—or perhaps some combination of all three. The results are unpredictable, but a Federal Reserve study of the consequences of caps on credit card interest rates identifies the most likely ones.[56] To cuts costs, issuers might tighten eligibility requirements, which would deny credit to lower-income families. In response, those unable to obtain credit cards would turn to even more costly forms of credit such a payday lenders, pawn shops, and rent-to-own stores (the so-called "substitution hypothesis").[57] Revenues could be increased by raising fees and adding new ones, which might affect even users who maintain no balance. Charges to retailers might be increased, which would affect all consumers, including those who pay with cash, if prices are raised on the goods sold. The total cost paid by users would be the same in the end, but the distribution of benefits and burdens of credit card use would change as a result of regulatory interference in the market.

These arguments against capping credit card interest rates have been challenged. Some proponents of caps question the extent to which the credit card market is competitive enough to ensure that rates align with costs. One study finds that returns in the credit card business are three to five times that of other areas of the banking business and attributes these outsized profits to consumer irrationality, especially about the size of balances.[58] The possible lack of competitiveness in the credit card market may also be the result of collusion among issuers, who follow a tacit agreement not to compete on interest rates. Factors like these, which reduce competitiveness in markets, are commonly addressed by government regulation, such as interest rates caps. Others dispute these claims and argue that the credit card market is quite competitive and that users' apparent insensitivity to interest rates may be rational, in part because of the low balances that many carry.[59] Other work indicates that low-income families are very rational in their use of credit. However, one consequence of this finding is that the substitution thesis—that they would be forced to use higher-cost forms of credit—is not borne out by the evidence, which suggests that the harm caps might impose on the poor is overstated.[60]

If the credit card market is not sufficiently competitive to justify the rates charged on the basis of costs, the remedy need not be caps or ceilings. The National Commission on Consumer Finance recommends in a 1972 report that the first priority should be on policies designed to promote competition. One focus of such policies should be on greater transparency so that users can easily comparison shop among the available offers. The report concludes, "As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed."[61] In this event, some caps or ceilings may still be necessary in credit markets, but only to prevent the most egregious gouging of vulnerable borrowers.

Mortgage Lending

After a Lehman Brothers executive visited a prospective client, a mortgage company in California named First Alliance, he wrote of his experience, "It is a requirement to leave your ethics at the door."[62] The inside, which he described as a sweatshop, housed salespeople, most of them from the automobile industry, who were pitching home loans, largely to unsophisticated elderly customers. He also wrote that, in the case of some loans, "the borrower has no real capacity for repayment" and that First Alliance was "the used car salesperson" of the subprime credit market. Despite these warnings and numerous pending suits from disgruntled customers, Lehman Brothers was convinced that the company had cleaned up its act and, in any event, that it had been doing nothing illegal. Subsequently, Lehman loaned the mortgage company around $500 million to continue its operations and underwrote $700 million in securities from loans originated by First Alliance.

Like many banks during this period, Lehman Brothers was deeply involved with subprime mortgages, which led not only to much distress among borrowers, including personal bankruptcy and loss of homes, but also to the near-collapse of the banking system from losses in mortgage-backed securities. Lehman itself disappeared in a spectacular bankruptcy in September 2008, which was a key event in the financial crisis. A main cause of Lehman's collapse was the firm's large holding of shaky mortgage-backed securities. In June 2003, a jury in California found Lehman guilty of "substantially assisting" First Alliance in defrauding homeowners by using high-pressure sales tactics that induced customers to refinance with loans in which high fees and interest rates were concealed or misrepresented. In some instances, fees up to 24 percent of the loan amount were imposed. One woman, who had sought to refinance a $14 000 credit card debt ended up with two mortgages, for which she was charged $18,000 in fees. By the time of the legal action against Lehman, First Alliance had gone out of business, after agreeing to a $60 million settlement in March 2002 with the Federal Trade Commission over allegations of consumer fraud.

Rise and fall of subprime

The decade leading up to the financial crisis was marked by a vast increase in the number of subprime mortgages issued to American homeowners. From 1996 to 2006, subprime mortgages as a percentage of all mortgages made rose from 9.5 to 23.5.[63] However, in 2008, the percentage of subprime mortgages dropped to 1.7, and the figure subsequently remained low due to tightened lending standards and a shortage of credit. Most of the independent loan origination companies that issued huge volumes of subprime mortgages have gone out of business or been absorbed by major banks. The mortgage brokerage business, which played a large role, has also largely disappeared. Although the damage done by this temporary rise and sudden fall of subprime mortgages lives on, this brief episode might seem to be of little significance for the present except that it dramatically illustrates the ways in which a potentially beneficial innovation can be abused, especially when it is combined with larger forces.

A case can be made that the advent of subprime mortgage lending had the potential for great social benefit. Prior to 1970, mortgage loans were available only for "prime" borrowers, who had the three critical features: a high credit rating, sufficient income to make payments easily, and a downpayment of at least 20 percent of the sale price. The only products generally available were conventional 15-year and 30-year fixed-rate mortgages. The reasons for the restriction of the market to prime borrowers were many, but, for one, the ability of banks (which were the major lenders) to extend mortgage loans was limited by their own deposits, which generally provided the funds. Since the loans were usually kept on a bank's own books, great caution was exercised to accept only the most creditworthy borrowers and to insist on good collateral that could be seized in the event of default. In addition, property appraisals were conservative in order to reduce the lender's risk. Furthermore, the market for selling loans, which was mainly the government-sponsored enterprises (GSEs) Fannie Mae and (after 1970) Freddie Mac, required so-called "conforming mortgages." These were 15-year and 30-year fixed-rate mortgages that met certain standards with regard to credit quality, loan-to-value ratios, and dollar amounts.

With home mortgage financing available only to prime borrowers, and with such a limited range of products, home ownership stood in 1970 at slightly less than 63 percent of American households, according to the US Census Bureau. Excluded from the ranks of homeowners were potential buyers who had sufficient income to make payments, though perhaps with some effort, and those who lacked sufficient time to build up enough savings. In addition, people with varied sources of income that fluctuated typically did not qualify for prime mortgages. More importantly, the requirements for a prime mortgage took no account of people's income growth potential. From an economic point of view, an efficient capital market should enable people to consume based on their lifetime wealth and not just their current level of income and savings. The removal of such time constraints is an important function of credit in an efficient market.

Since many of the people who were excluded from the home mortgage market were members of racial minorities, these restrictions on lending tended to exacerbate the deep-seated problem of discrimination. Moreover, homeownership is critical for most families in building wealth, and so many of those excluded from the mortgage market, which were predominantly low-income groups, increased the problems of poverty and inequality. Homeownership is also linked to the development of strong families and communities, and so it is an important social goal that has been encouraged in the US and elsewhere for decades by government policy.

Beginning in 1970, innovations in mortgage lending greatly expanded the opportunities for people previously excluded to enter the ranks of homeowners. These new products included adjustable-rate mortgages (ARMs), mortgages with balloon payments and low initial payments (so-called "teaser rates" that re-set after two or three years), no-money-down loans, second mortgages (often providing the needed downpayment), and home equity lines of credit. A study by the National Bureau of Economic Research found that the development of unconventional loans from 1970 to 2000 greatly increased home ownership, especially among the young and racial minorities, without significantly impairing loan quality.[64] By 2000, the homeownership rate had increased to 66.2 percent and had greatly boosted participation by racial minority groups, which had often suffered discrimination in mortgage lending. Furthermore, the default rate on subprime mortgages was consistently low, in single digits, in the 1970 to 2000 period. It was less than 11 percent as late as 2005, although that sector had been weakening, unnoticed, for some time.

The social benefits of subprime mortgage lending make a compelling case: many people who would otherwise be unable to purchase a suitable home have been able to do so, and, at the same time, a number of pressing social problems in society have been addressed. Subprime mortgages pose greater risks not only to lenders, because of higher default rates, but also to borrowers, who may lose money in foreclosure if they are unable to make the payments. However, the higher default rate can be factored into the interest charged and also offset by mortgage insurance (which was generally required on subprime loans). The risk to borrowers is also limited if a home can be sold or easily refinanced in the event of financial distress, and if housing prices rise significantly. More importantly, the main factors that limited credit to prime borrowers, which were limited funds and bank risk, were overcome by a new development—the securitization of home mortgages. In one fell swoop, this innovation opened the world's credit supply for home mortgages and transferred the risk to the world's investors.

Securitization

Securitization is the process by which financial instruments are created by combining multiple assets of any kind into a common pool, dividing this pool into parts with different features, and selling the rights in each part to investors. The most common assets in securitization are expected payments from home mortgages, auto loans, student loans, and credit card debt. The simplest form of securitization is an asset-backed security (ABS) or, when the assets backing the security are mortgages, a mortgage-backed security (MBS). In an ABS or MBS, the pool of loans serves as collateral for a security that offers investors a right to all future payments, minus a fee to the arranger or *securitizer*. More common is a complex security called a *collateralized debt obligation* (CDO) in which the common pool is divided in parts or *tranches* that carry different rates of return and levels of risk. The risks in different tranches result from the order of payment, since investors in less risky tranches with the lowest rates are paid first, while the most risky tranches with the highest rate suffer the losses from the first defaults.

In the financial crisis, the production of CDOs was deeply entwined with the origination of subprime mortgages, since the enormous fees to the securitizers (which were mostly large investment banks) led them to demand an ever increasing supply of home mortgages. These fees were possible, in turn, because of the heavy demand from investors worldwide for CDOs because of their high return. Although the resulting deterioration of credit quality in home mortgages—prime as well as subprime—led to the crisis, securitization itself has many benefits.

First, by shifting the risk of loan defaults to holders of CDOs, securitization removes the risk from local banks, which are relatively undiversified and hence more risk averse, and places the risk on investors around the world, who are more willing and able to bear the risk. This ability to bear risk more efficiently also reduces the cost of risk bearing in making loans, which reduces interest rates. Second, this transfer of risk also enables banks to make more home loans, not only because they do not bear the risk but also because loan funds are available from investors worldwide and not merely from a bank's own depositors. Although less creditworthy borrowers may default at higher rates, many can successfully repay loans, and as long as default rates are known, a higher interest rate can be charged to compensate for the greater risk. Moreover, the risk of loaning to less creditworthy borrowers is not excessive under certain assumptions. As long as housing prices continue to rise, borrowers who are unable to make payments can refinance or sell their properties, and if the loans are well collateralized, then the risks to the lender are relatively small. (Needless to say, these conditions ceased to prevail during the financial crisis.)

Finally, securitization provides an ample supply of high-earning, high-rated securities to meet investor demand. (This demand, too, quickly dried up in the crisis.) The seemingly magical power to turn risky subprime mortgages into AAA-rated securities is perhaps the most remarkable feature of CDOs.

The key to this power is the point that in a pool of mortgages, each one of which would alone receive a low rating, only some percentage will default. If the highest tranches are paid first from nondefaulting mortgages, then almost all the mortgages in a pool would have to default before the losses affected these highest tranches. Since such a high default rate is unlikely to occur, even among a pool of all subprime mortgages, these tranches are very safe and hence deserving of a triple-A rating.

The flaws in this seemingly magical transformation of dross into gold are that, first, the lowest tranches, which are affected by the first defaults, are very risky; second, defaults were far in excess of predictions and thus affected higher tranches; and, third, the highest tranches became difficult to value, so they became worthless as collateral for loans since no one knew what they were worth. In the crisis, many CDOs retained their value and their AAA rating but they became illiquid.

What went wrong?

Despite the great potential for social benefit, America's brief boom in subprime mortgage lending turned into a bust. What went wrong? The subprime mortgage bust has many causes, some of which arise from the loans themselves and how they were marketed, while others involve larger forces, including a house price bubble, problems with securitization, and the risks taken by banks. The recent financial crisis, too, had many causes, of which subprime mortgages was only one. The whole crisis is a story of complex interactions among many factors. The focus here is confined to the question of how subprime mortgage lending failed to realize its promise and instead resulted in millions of people losing their homes to foreclosure, often with a loss of their whole savings, or else ending up "underwater," owing more on a mortgage than their house was worth. Only some of these causes involve ethical faults, but these are significant failings from which some important lessons can be learned.

Predatory lending

The most obvious but perhaps least consequential cause of the subprime bust was predatory lending of the kind practiced by First Alliance and aided by Lehman Brothers. The harm that predatory lending can do to victimized borrowers may be substantial, especially when it is done on a large scale, and the harm is all the more egregious when it is done deliberately with loans that the lender knows cannot be repaid and will likely ruin the borrower. However, predatory lending has been prevalent in most economies with loans of all kinds without causing the extensive devastation experienced recently. The consequences of predatory lending are usually confined to the victims with little or no systemic impact, such as the collapse in housing prices, which affected almost everyone in the economy. Moreover, many homeowners have been trapped by mortgages, both subprime and prime, which were entirely free of any predation, and it is likely that the subprime bust would have occurred anyway without any predatory lending.

Predatory lending lacks a precise definition, but roughly a loan is predatory when the lender uses unscrupulous means to induce a borrower to take a loan that the lender knows or should know will likely inflict harm on the borrower. The harm in this case may result from loss due to foreclosure when payments cannot be made, or else from a loss of an opportunity to be better off, as when qualified borrowers are steered toward loans with higher interest rates. The means used may be unscrupulous not only in cases of outright fraud but also when high-pressure sales tactics are used. Determining when a loan is predatory is difficult, especially in the case of subprime borrowers who must take greater risks in order to obtain a loan. A subprime mortgage is already risky for a borrower, so when is the risk so great that it ought not to be undertaken? Who is to make this judgment? Furthermore, a lender may be the victim of predatory borrowing when a loan applicant misrepresents certain facts.

Federal regulators have identified three elements in predatory or abusive subprime lending.[65] First, it occurs when important terms of a loan are concealed or disguised or otherwise not made known, especially to an unsuspecting or unsophisticated borrower. Such actions generally constitute fraud, which is compounded when the terms involve unconscionably high interest rates, exorbitant points or fees, or onerous restrictions, including high prepayment penalties. Second, it is predatory to induce borrowers to refinance unnecessarily into new loans repeatedly in order to collect additional fees, which is a process known as "flipping." A third element of predatory lending is judging creditworthiness on the basis not of a borrower's ability to repay but of the value of the collateral. This practice is considered predatory because the lender is making a loan with the intent of seizing the property in question when the borrower, as expected, defaults. Such loans are merely devious ways of acquiring property by stealth.

The first of these elements—concealing or misrepresenting crucial information—raises questions about what a lender ought to disclose and perhaps ensure that a borrower understands. Among such information are balloon payments; payments that may be increased due to interest-rate resets on adjustable-rate mortgages or mortgages with low initial "teaser rates"; fees or penalties that may be incurred, especially for prepayment of loans and up-front, single-premium mortgage insurance; and the costs of taxes and insurance, especially if these are not escrowed and included in monthly payments. Information about such matters is crucial to ensure that borrowers are prepared to pay the full costs of homeownership and are not surprised by the amounts required. In addition, the failure to disclose that the borrower may qualify for mortgages with more favorable terms, including prime loans, is a form of predatory lending known as "steering," which is often done when less suitable loans generate more fees for the originator.

Predatory lending is generally illegal, and so one factor in the subprime bust is ineffective enforcement of existing regulation. In the United States there are many laws, both federal and state, that forbid certain abusive practices, as well as many regulatory agencies with responsibility for enforcing these laws. Victims of predatory lending are also able to sue in court, as many have. A major cause of the subprime bust was the failure of regulatory agencies to effectively enforce laws already on the books. The Federal Reserve Board explicitly declined to take action in the belief that it lacked sufficient resources to prevent abuses.[66] The fragmentation of the American banking regulation system further impeded enforcement, and state regulators who took aggressive action were ordered, in some instances, to desist by federal bodies, which claimed jurisdiction. In addition, much of the origination of subprime mortgages was done by nonbank institutions that were beyond the reach of bank regulators. This lack of supervision in the subprime sector, where it was needed most, was described by Edward M. Gramlich as "like a city with murder laws but no cops on the beat."[67]

Toxic products

In 2006, Angelo Mozilo, the CEO of Countrywide—a notorious subprime mortgage originator, now part of Bank of America—wrote a memo describing a new mortgage for the full value of a home as "the most dangerous product in existence and there can be nothing more toxic."[68] In context, Mozilo was urging great care in the sale of this product,[69] but he still recognized the danger inherent in one of his company's best sellers. Subprime mortgage lending, which had great potential for good, was made possible only by the development of innovative products, but these same products became the gunpowder that blew up the market. There are, perhaps, some financial products that are inherently "toxic" and should not be sold to anyone, but the main problems with subprime mortgages were not only how they were sold (that is a matter of predatory lending) but also to whom they were sold (which is a problem of suitability) and in what quantity. All three of these factors were crucial in the subprime mortgage bust.

Probably no single mortgage product deserves the label "toxic," even Countrywide's 100 percent, no-money-down loan, which may be appropriate for some people. Indeed, most of the subprime innovations were designed to fit the needs of specific, often prime, borrowers. For example, so-called option ARMs, which allowed borrowers to pay less than the stated interest, with the shortfall added to the principal (negative amortization), were created originally for wealthy homeowners who wanted the benefit of low immediate payments.[70] Such a product may also be of benefit to cash-strapped prospective homeowners who expect to increase their wealth over time. Furthermore, the available subprime mortgages made sense under certain assumptions, including rising home prices. (Had they ever fallen? Well, yes, but not in living memory.) Other assumptions include access to refinancing and/or ease of sale. Under the conditions that prevailed up to 2006, both borrowers and lenders saw limited downside risk in even the most unconventional mortgages.

Some of the risk involved in subprime mortgages could not have been easily foreseen, but some borrowers were undeniably careless in assessing their ability to pay, and lenders were only too eager to assist them. Both originators and mortgage brokers pitched unnecessarily complex products that would befuddle even sophisticated customers. However, the inescapable conclusion is that mortgages were sold to people who should not have been homebuyers in the first place. The problem was not lack of *suitability* (getting the right mortgage) but of *qualification* (obtaining any mortgage at all). Lenders were qualifying applicants for mortgages either by relaxing standards or, in some cases, by falsifying information. The latter, of course, is a form of fraud.

Relaxed underwriting standards can turn good products toxic by putting them in the wrong hands—of people who should not have them at all. This lowering of standards can take many forms that are not easily detected. One form is failing to adequately document information that, if correct, would be qualifying. Such "low-doc," "no-doc," or "stated income" loans may formally meet underwriting standards but disguise the falsity of the information. These types of loans were developed to accommodate people with erratic and difficult-to-verify sources of income, such as self-employed professionals, but their use was eventually extended, improperly, to ordinary wage earners, whose income could be exaggerated.

Second, borrowers may be qualified for mortgages with low initial payments but not for the costs later when the rate resets, or for mortgages alone without considering the other costs of ownership, such as taxes, insurance, and maintenance. A third form of relaxed standards is "risk layering," in which numerous small risk factors combine to produce a large risk. Thus, a borrower may have no single disqualifying risk characteristic, but if enough small ones are ignored, then creditworthiness may be significantly misjudged. Similarly, a borrower may qualify for a loan with one kind of risk feature, but if multiple risks are "layered," then the loan may be too risky for this borrower.

Perverse incentives

The subprime bust cannot be understood without some mention of the incentives that led mortgage originators to engage in predatory lending and offer toxic products.[71] The main cause of these perverse incentives is, in a word, *securitization*. Like subprime mortgages themselves, securitization is a potentially beneficial innovation that is not without its dangers when wrongly used.

When banks originate mortgages and hold them on their books, they have very strong incentives to select only the most creditworthy borrowers and verify information about both the borrower and the property being bought. This system, which prevailed before 1970, may be called *originate-to-hold*. In securitization, pools of loans are bundled together and sold as securities to investors. When this became common in the 1990s, the link between origination and holding was broken: the originator no longer held the resulting mortgages; rather they were now held by investors worldwide. The result is the *originate-to-distribute* system. In the transition from originate-to-hold to originate-to-distribute, the incentives for lenders were fundamentally transformed. Furthermore, securitization introduces many new parties, including the securitizers and the ultimate investors, which each have their own incentives.

In the originate-to-distribute system, one incentive for originators is to focus on volume. Since originators are paid a fee by the securitizers for each mortgage sold to them and are able to collect fees from borrowers as well, the number of loans originated is critical. Banks that hold mortgages need to make some loans, but the number is limited by their available funds; therefore more is not necessarily better. Since originate-to-hold lenders have little need to attract borrowers—indeed, they are often turned away—loans are made to people who are likely to be more creditworthy than are potential borrowers who must be persuaded to refinance or become a first-time homeowner. The different situation of mortgage originators who sell their loans to securitizers explains their aggressive search during the peak years to find more and more borrowers, often through direct-mail marketing and cold-calling. Few prospects would be turned away.

Under the originate-to-distribute system, the creditworthiness of borrowers is inconsequential as long as it is accurately represented. Loans of any quality can be securitized if the risk is known and correctly priced. Indeed, risky subprime mortgages with high interest rates were in great demand for securitization during the peak years because of the greater return. Although accuracy in the representation of risk is important in selling mortgages to securitizers, it is less urgent to the originators than to banks that keep loans on their own books, because once loans are sold, any inaccuracy is the problem of the buyer. Moreover, the responsibility for ensuring accuracy is split in the originate-to-distribute system between the buyer (the securitizer and ultimately investors) and the seller (the originator), which reduces the strength of the incentive for each.

Although the value of the property being financed is important for all lenders, the incentives vary between the two systems. A bank that originates-to-hold has an interest in ensuring that the property is worth the amount claimed because that is the collateral for the loan, and it typically engages a reliable appraiser to determine the value. Furthermore, the appraiser would be urged by the bank to estimate conservatively, so that in the event of default, the amount loaned could be recovered by seizing the collateral. When a bank is unwilling to loan more than 80 percent of the appraised value, the loan amount will be low with a conservative appraisal and more than 20 percent of the actual sale price may be required for a down payment.

When loans are originated to be distributed, however, the lender is less concerned with an accurate appraisal for the same reason that accuracy about creditworthiness of the borrower is relatively unimportant. More importantly, the originate-to-distribute lender has in interest in inflating the value of the property so that the face amount of the loan is higher, since that amount is the basis for the fee obtained from the securitizer. A higher face value can also be achieved by lowering the amount of the downpayment, which raises the principal of the loan. Thus, a 100 percent mortgage on a house with an inflated appraisal is very attractive to a lender in the originate-to-distribute system but anathema in the originate-to-hold system.

Under both systems, the lender has incentives to make mortgages with the highest possible interest rate and the most fees, since these are the main sources of income. Income can also be increased by designing loans that may need to be refinanced. However, if onerous terms lead to default, then a bank that holds the loan suffers, but the originate-to-distribute lender is unaffected. So the former lender has an incentive the latter lacks to avoid onerous terms. Also, banks that hold mortgages are more rooted in communities and have a reputation to protect, which create additional incentives to moderate their conduct.

Moreover, the type of loan—prime or subprime, conforming or not—is of greater interest to a lender when loans are sold to securitizers. Banks that hold mortgages generally have little interest in subprime loans, but when these are in greater demand by securitizers, originate-to-distribute lenders would seek to obtain more of them, perhaps by steering prime borrowers into subprime loans. Nonconforming loans, in fact, were demanded by securitizers during the peak years because they were seeking to take market share away from the

GSEs (Fannie Mae and Freddie Mac), which, at least initially, would buy only conforming loans.

Although securitization impacted mainly the incentives for lenders, borrowers, too, were affected. Since securitization greatly lowered the costs of obtaining a mortgage and expanded the supply of credit, that fact, combined with escalating house prices, drew many speculators into the market for investment properties that could be quickly “flipped” for a tidy profit. The same factors also induced many homeowners to take out home equity loans or to refinance into higher-principal loans in order to obtain ready cash, thereby using the home as a “piggy bank.” Thus, predatory lenders were joined by predatory borrowers, who would use deception and misrepresentation to obtain loans for which, in some case, they were not qualified.

The originate-to-distribute system also created a new role—the mortgage broker, who mediated between borrowers and the originators. Their role in mortgage origination was negligible as late as 1960, but at the peak of the market in the 2000s, brokers originated approximately two-thirds of all mortgages.[72] Today, mortgage brokers have virtually disappeared.[73] Contrary to the belief of many borrowers, mortgage brokers are responsible only to themselves; they are solely intermediaries between borrowers and lenders, with no fiduciary duty to either. Since they are paid by originators, their incentives are largely aligned with them—“Get ‘em what they want!”—but their main interest lies in getting the deal closed on any terms, because only then do they get paid. However, the opportunity also exists for brokers to conspire with borrowers to misrepresent or conceal information when that is necessary for obtaining a mortgage, or to broker loans that benefit neither borrower nor lender but enrich themselves.

The aftermath

Although the subprime mortgage market is now largely in the past, the effects linger. After the major banks bought up the main independent mortgage companies in order to secure a steady supply of mortgages to securitize, the subprime mortgage business collapsed during the financial crisis. The misdeeds of these mortgage companies now haunt their buyers, the major banks, as homeowners, investors, and governments bring suits against them. The ethical problems with subprime mortgages have shifted from origination to foreclosure, as questions are raised about the obligations of the banks in helping distressed homeowners to cope with their desperate situations.

Although money was allocated by the US government to finance foreclosures, little has been done by the major banks, which have benefited greatly from the infusion of taxpayers’ money to avert their collapse. Homeowners complain, "The banks got bailed out, while we got sold out!" However, efforts to address issues in foreclosure are hampered by two legitimate ethical concerns. For one, the public perceives the plight of some homeowners as due to their own greed. Many agree with the ungrammatical rant of the television personality Rick Santelli, who asked on the air, "How many people want to pay for your neighbor's mortgages that has an extra bathroom and can't pay their bills?" In addition, many of the mortgages in question have been sliced and diced into countless securities owned by people all over the world, in which the return owed is guaranteed by contract. Many homeowners may have been wronged, but correcting these wrongs might violate the property rights of these contract holders, which would also be a wrong.

A final ethical issue in the aftermath of the subprime bust is the ethics of homeowners defaulting on mortgages when they are able to make payments. This has become known as "jingle mail," because of the sound that an envelope full of keys makes when it is sent by a homeowner to the mortgage servicer (It's yours now!). In nonrecourse jurisdictions, where creditors cannot seize more than the asset held as collateral (a house in the case of a mortgage), it may make economic sense for an "underwater" homeowner who owes more on a mortgage than a house is worth to simply walk away and let the bank take possession. The fact that few "underwater" homeowners have actually done this is in need of explanation. One possibility is that some combination of shame, guilt, and fear deter them from doing what is otherwise rational.[74] Others argue that walking away or "jingle mail" is not as economically rational, nor as morally permissible, as may first appear.[75]

Although the banking industry argues vigorously that a homeowner has promised to repay a loan—and, of course, promises should be kept—this industry also argues that a contract is a contract and ought to be followed, regardless of moral considerations. (This is why contracts should not be modified in foreclosure, for example.) Is the banking industry guilty of inconsistency in this stand? Moreover, the contract in question, the mortgage document, provides for a remedy in the event of default, which is generally limited to bank seizure of the property. It may be argued that the bank has, in effect, sold the homeowner a put option to sell back the property, and that the homeowner is merely exercising this option. Would a bank say that it had an obligation to decline the right to exercise an option due to moral concerns? After all, it is exercising an option in proceeding with foreclosure without regard for the human cost, and some homeowners' distress, it may be argued, was caused by the banks in the first place. So, do they have a right to compound this harm by foreclosing on properties when mortgage modification is also possible? The aftermath of the subprime bust leaves many ethical questions unanswered.

Arbitration

The American humorist Alexander Woollcott once quipped that a broker is "a man who runs your fortune into a shoestring." Unfortunately, not a few investors have entrusted their life savings to a broker only to discover their once-large nest egg consumed by churning, unauthorized trading, or the failure of a broker to follow orders—or simply by a broker's incompetence. The problem is not confined to brokers. Bank customers, credit card holders, mutual fund investors, insurance policy holders, and a wide variety of other ordinary people find that they have suffered losses from possible misconduct by financial services providers.

Justice requires that the victims of abuse or incompetence be compensated for their losses and perhaps that the wrongdoers be punished. Of course, customers or clients may attempt to blame financial services providers for their own failures and misfortunes, and so a method for settling disputes is required, lest an injustice be done to either party. The court system is designed to handle disputes of this kind in a just manner, but costly and lengthy legal battles often do not serve anyone's interests. Individuals who have few resources or whose losses are minor would be deterred from seeking compensation if a court fight were their only recourse, while financial services firms would face constant litigation if every disgruntled customer or client were to sue.

Arbitration, instead of litigation, appears to be a quick, low-cost method of dispute resolution that serves the interests of all concerned. Most labor contracts, for example, provide for binding arbitration because of the advantages over court action. Similarly, in the securities industry, predispute arbitration agreements (PDAAs), which commit customers or clients (and often employees) to binding arbitration, are standard. Many investors are precluded, therefore, from suing in court and are forced to submit disputes to a panel of arbitrators. In addition, employees who might otherwise be able to sue for discrimination or other illegal treatment are often forced into arbitration, and credit card customers, insurance policy holders, and other users of financial services are increasingly being required to arbitrate disputes. Despite the virtues of arbitration, the process is open to abuse, and critics charge that many injured parties have been denied justice. Arbitration, they say, is heavily weighted in favor of the industry, so that people who have been wronged once by dishonesty or incompetence are wronged yet again by a bullying firm. Some of the most elemental principles of due process are not observed by arbitration panels. In addition, the promise of quick, low-cost dispute resolution has not always been realized because arbitration is sometimes as hard-fought as court battles. The industry itself complains that unpredictable punitive damage awards expose firms to potentially heavy liability. All sides in the arbitration controversy recognize the need for thoroughgoing reform.

In 1994, the NASD, which at the time handled 85 percent of all arbitration claims in the securities industry, appointed an eight-member Arbitration Policy Task Force under former SEC chairman David S. Ruder to make recommendations for an overhaul of the current system. The task force report, *Securities Arbitration Reform*, which was issued in January 1996, contains more than 70 recommendations that represent, according to a press release, "the most comprehensive revamping of securities industry arbitration since it was established to resolve investor disputes more than a century ago."[76] The so-called Ruder Commission investigated four main areas of concern: the requirement of compulsory arbitration through the use of PDAAs; the hardball legal tactics of securities firms; the competence and accountability of arbitrators; and the permissibility of punitive damages.

Compulsory arbitration

Investors who open accounts with a brokerage firm are usually asked to sign a PDAA. These agreements are required for virtually all margin or option accounts and more than 60 percent of money management accounts, but not commonly for cash trading accounts. Customers who refuse to waive the right to sue will generally be told to go elsewhere, but they will find the same form awaiting them at any other firm. Can investors be said to agree voluntarily to compulsory arbitration if signing a PDAA is a condition of doing business with a brokerage firm? One congressional critic of arbitration describes "fair compulsion" as an oxymoron and contends, "Investors should not be forced to make the Faustian bargain of signing away rights to litigate in order to invest in our financial markets."[77]

The law for self-regulating organizations (SROs), under which NASD is organized, and the NASD code permit customers to insist that any dispute be arbitrated, regardless of whether a PDAA has been signed, but legally customers have a right to litigate—unless, of course, they waive that right. However, at least two questions must be asked about compulsory arbitration agreements. Should the law permit firms to require that investors sign a PDAA as a condition of opening an account? In particular, should a PDAA be legally enforceable if compulsory arbitration does not enable an investor to protect rights granted by law?

In 1987, the US Supreme Court addressed these questions in *Shearson/American Express, Inc. v. McMahon*.[78] The court unanimously upheld the right of the securities industry to require customers to submit claims to arbitration on the grounds that the law merely supports a federal policy favoring arbitration by SROs. In short, it is the judgment of Congress that the American public is better served by arbitration, rather than litigation, in the securities industry. The right to require a PDAA does not apply to an agreement that results from fraud, but this exception aside, PDAAs are legally enforceable. Investors also have a right under securities law not to be defrauded by brokers. Do PDAAs require investors to forgo this legal protection? No, the court ruled in the *McMahon* decision, as long as arbitration is reasonably effective in enforcing investor rights in securities transactions. Whether arbitration provides sufficient protection is a matter for Congress, not the courts, to decide. The bottom line, however, is that PDAAs are fair to investors only if they effectively protect all investor rights.

Other ethical and legal issues are whether investors should be told that they are agreeing to compulsory arbitration by opening an account, and whether they should understand fully what signing a PDAA entails. Customers complain that the agreement provisions are expressed in impenetrable legal language buried deep inside the documents for opening an account. Many people do not realize that the rules for arbitration are different from those in the courts. The Ruder Commission report specifically recommends that the PDAA be highlighted and that investors be required to acknowledge the agreement in writing. Further, the following disclosures should be prominently displayed:

1. Arbitration is final and binding on the parties.
2. The parties are waiving their right to seek remedies in court, including the right to a jury trial.
3. Discovery is generally more limited and different from discovery in judicial proceedings.
4. The arbitrator's award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of the arbitrator's rulings is strictly limited.
5. The panel of arbitrators will typically include a minority of arbitrators who were, or are, affiliated with the securities industry.[79]

Some states, most notably New York, do not permit punitive damages in securities arbitration. Whether arbitration agreements involving customers and firms in other states can include waivers of any right to punitive damages is unclear, but in any event, some investors have signed PDAAs that preclude punitive damages without being aware of having done so. Prior to 1995, many brokerage firms inserted a clause in their PDAAs that specified that in arbitration the laws of New York State will prevail, without adding, of course, that these laws prohibit punitive damages. A college professor in Chicago named Antonio C. Mastrobuono signed such an agreement with Shearson Lehmann Hutton, Inc., little realizing the implications, and when he won punitive damages from an arbitration panel, the brokerage firm filed suit to block the award, contending that Mastrobuono had waived the right to punitive damages. In a 1995 decision, the Supreme Court found in favor of Mastrobuono on the grounds that the contract was not sufficiently explicit, although the high court did not express an opinion on either the merit of awarding punitive damages or the ethics of hiding a waiver in nonrevealing language. Professor Mastrobuono, a Dante scholar, was more forthcoming: "To allow Wall Street to steal from customers and then limit what they can recover in a forum of its choosing," he said, "would be institutional immorality worthy of punishment in Dante's fourth circle of hell."[80]

Hardball legal tactics

Although arbitration is intended to be less formal than a court trial, it has become a legal battleground in which platoons of lawyers from both sides fight tooth and nail over every aspect of the proceedings. Despite their professed commitment to arbitration, brokerage firms have eagerly gone to court to get their way in arbitration. Thus, investors who can seek justice only through arbitration face a foe who can fight in two arenas at once.

The main points of contention in arbitration and litigation are: (1) the eligibility of a claim for arbitration, especially whether the time limit for making claims has expired; (2) the rules to be followed, especially those governing the admissibility of evidence and the applicable law; and (3) the documents that must be produced in discovery. Investors have accused brokerage firms of refusing to produce documents or delaying as long as possible, and although arbitration panels have subpoena power, they rarely exercise it or exact consequences for noncompliance. Many complaints are settled before they reach an arbitration panel, some no doubt on generous terms, but brokerage firms have been known to take advantage of investors' lack of resources and uncertain prospects to settle cheaply. Virtually all settlements contain confidentiality agreements that prevent unfavorable publicity about problem brokers and their firms. In general, customers who enter arbitration can expect a hardball legal approach from brokerage firms seeking to minimize legal liability, no matter the cost to the industry's reputation for fair treatment of customers.

The Ruder Commission report addressed these problems with three main recommendations.[81]

(1) *Bar collateral court litigation over procedural issues in arbitration until after the arbitration award.* The Commission recommends that the parties seek to resolve procedural issues in the arbitration forum and delay any court litigation until the arbitration panel has ruled.
(2) *Suspend the six-year eligibility rules and resolve issues of whether an arbitration claim is time barred by more vigorously applying applicable state and federal statutes of limitations.* Under the current rule, claims must be brought within six years of the alleged wrongdoing. Aside from the fact that some investors might not discover fraudulent activity within this period of time, the six-year rule is difficult to apply because of uncertainty over the date of the alleged offence.
(3) *Simplify document production and other discovery, and require early resolution of any discovery dispute.* The Commission concluded from its study that the process of obtaining documents from the opposing side was a main obstacle to quick, low-cost arbitration and the source of much collateral litigation. Discovery is also abused by lawyers who use "vacuum-cleaner" tactics, common in civil litigation, that seek to gain all available evidence and at the same time burden the opposing side with heavy production requirements.

Problems with arbitrators

Critics of arbitration complain that some arbitrators are inattentive to the proceedings, ignorant of the relevant law and of arbitration procedures, capricious and inconsistent in their rulings, and biased in favor of the industry. Arbitrators, for their part, feel overburdened and undercompensated, and they lament the lack of time and resources for more training. Some of the complaints about arbitrators are compounded by the rules for arbitration. For example, at least one arbitrator on a panel must have ties to the industry, thus creating an impression of a stacked deck. The limited number of arbitrators and the limited opportunity of the parties to select among them reduce confidence in the system. Arbitration panels typically do not explain their reasoning, nor can their decisions be appealed. Thus, the parties are deprived of any basis for judging the soundness of the decision-making process or the competence of the decision makers.

The Ruder Commission report notes a tension between a traditional model of arbitrators as peers, who draw upon their knowledge and experience, and a more recent model of professional, full-time arbitrators, not unlike the judiciary.[82] The traditional model may have served the securities industry well in the past, but the report suggests that the time has come for the shift to the professional model that prevails in labor relations and large commercial disputes. In addition to making numerous recommendations for improvements in the training and compensation of arbitrators and an increase in their number, the Ruder Commission report also proposes that complaints involving smaller amounts be arbitrated using simplified procedures. Also, greater use should be made of mediation and "early neutral evaluation" (ENE).

Punitive damages

The Ruder Commission report observes, "No subject has generated more controversy or so polarized opinion between the investor community and the securities industry than the availability of punitive damages in securities arbitration."[83] The industry has made the elimination of punitive damages its main goal, while investors have sought to maintain the possibility of punitive damage awards.

The industry view is that arbitration is intended to compensate investors for actual losses, not to punish individuals and firms for past misconduct or to deter them from future misconduct. If arbitration panels were to aim at punishment and deterrence, then they would have to consider many factors besides the case at hand. Moreover, punishment and deterrence are the province of the state and ought to be left to regulators acting to protect the public, not to arbitrators who are settling private disputes. Because punitive damages can be enormous, it is unfair that they be imposed in proceedings that lack important procedural safeguards, such as the consideration of all relevant information and the right of appeal. Finally, the possibility of punitive damages raises the stakes for brokerage firms and induces them to take a hardball legal approach.

Investors argue that punitive damages protect against predatory behavior by brokerage firms. Since the *McMahon* decision permits brokerage firms to require PDAAs as a condition of opening an account and to force customers to settle disputes through arbitration, investors should not be further deprived of a remedy that would otherwise be available in civil litigation. In short, investors should have the same remedies in arbitration that they have in court—especially since they have little say in the choice of venues. This principle is expressed, moreover, in SEC and NASD rules that prohibit the placing of any restrictions on arbitrators with regard to the kind and amount of awards.

The Ruder Commission concedes the merits of both views and does not side with either one. Instead, the report offers a compromise position: that punitive damages be retained subject to a cap. Specifically, the proposed cap is the lesser of two times the compensatory damages, or $750 000. The main benefit of a cap, whatever the amount, is to alleviate industry concern with the unlimited exposure that exists under the present system. The recommended amount is high enough that few investors would be affected. In addition, the Ruder Commission report proposes that the availability of punitive damages in arbitration be determined by whether punitive damages would be available in court for the same claim under the laws of the investor's state at the time that the claim was filed. "By this standard," the report notes, "investors will be no better or worse off than if they had brought their claim to a judicial forum."[84]

Disputes between investors and brokers are inevitable, and so some means of just resolution must be available. However, the securities industry should also aim to eliminate the causes of disputes, and not merely deal with them as they arise. As a commentator in *BusinessWeek* observed, "The industry's proposals simply amount to a more efficient shovel brigade for the elephant parade. Instead, the industry should work on the front end to prevent abuses in the first place."[85]

Conclusion

Retail customers of financial services are especially vulnerable since the providers of these services typically have great powers that can be easily abused, and they also have strong incentives to do so. For their part, customers vary greatly in their financial knowledge and sophistication, and given the importance of financial services to our lives, everyone should be able to utilize them without fear of being abused. Although the market provides customers with considerable protection—no bank, for example, can survive without great trust and loyalty—substantial regulation is also necessary. This regulation is often guided by ethics since questions often arise about the duties or obligations of financial services providers to customers, as well as about the rights of consumers. In addition, the ethical treatment of customers goes beyond what markets and regulation would impose. Providers must determine what is ethical in their treatment of customers and how to implement ethical standards through their practices and policies. The main topics in this chapter—sales practices, credit cards, mortgage lending, and arbitration—do not exhaust those that affect retail customers, and, indeed, much of this book is relevant to the vulnerability that we all feel in dealing with the world of finance.

Notes

1. "Burned by Merrill," *Business Week*, April 25, 1994.
2. Ellen E. Schultz, "You Need a Translator for Latest Sales Pitch," *Wall Street Journal*, February 14, 1994.

3. Michael Quint, "Met Life Shakes Up Its Ranks," *New York Times*, October 29, 1994.
4. Penelope Wang, "Why Mutual Funds Investors Need a Truth-in-Labeling Law," *Money Magazine*, October 1995; John S. Longstaff, "Has Your Mutual Fund Changed its Personality?" *Money Magazine*, January 1996.
5. Ellen E. Schultz, "SEC Staff Supports Limited Disclosure of Variable-Annuity Fees in Ad Charts," *Wall Street Journal*, November 7, 1995.
6. Schultz, "SEC Staff Supports Limited Disclosure of Variable-Annuity Fees in Ad Charts."
7. Stanley Luxenberg, "Who's Churning Whom?" *Forbes*, December 1985.
8. Jeff Bailey, "A Man and His Loan: Why Bennie Roberts Refinanced 10 Times," *Wall Street Journal*, April 23, 1997.
9. Walt Bogdanish, "Irate Borrowers Accuse ITT's Loan Companies of Deceptive Practices," *Wall Street Journal*, February 26, 1985; Charles McCoy, "ITT Unit Settles Fraud Charges in California," *Wall Street Journal*, September 22, 1989.
10. Robert Berner, "U.S. Files Suit Against Sears Roebuck Charging Unfair Card Debt Collection," *Wall Street Journal*, April 18, 1997.
11. *Report of the Committee on Compensation Practices*, issued by the Securities and Exchange Commission, April 10, 1995.
12. *Report of the Committee on Compensation Practices*.
13. *Marshak v. Blyth Eastman Dillon & Co. Inc.*, 413 F. Supp. 377, 379 (1975).
14. *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith*, 464 F. Supp. 528, 534 (1978).
15. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); 96 S. Ct. 1375, 1381 (1976).
16. The formula is ATR $= P/E \times 365/D$, where $P =$ total cost of purchases made during a given period, $E =$ average equity in the account during the same period, and $D =$ number of days during the period.
17. Marion V. Heacock, Kendall P. Hill, and Seth C. Anderson, "Churning: An Ethical Issue in Finance," *Business and Professional Ethics Journal*, 6 (1987), 3–17.
18. For objections to these measures, see Robert F. Almeder and Milton Snoeyenbos, "Churning: Ethical and Legal Issues," *Business and Professional Ethics Journal*, 6 (1987), 22–3l.
19. *Hecht v. Harris, Upham & Co.*, 238 F. Supp. 417, 435 (1968).
20. *NASD Rules of Fair Practice*, art. III, sec. 2.
21. Harry M. Markowitz, "Portfolio Selection," *Journal of Finance*, 7 (1952), 77–91; and Harry M. Markowitz, *Portfolio Selection* (New Haven, CT: Yale University Press, 1959).
22. The issuers of credit cards are mainly banks or credit unions, although some large retailers issue their own credit cards. Since banks are the dominant issuer of credit cards, the terms "issuer" and "bank" are used here interchangeably. Credit cards also require a payment system for processing transactions between customers and retailers. The two major payment systems are MasterCard and Visa, but some issuers, such as American Express and Discover, provide their own payment system. The role of payment systems is excluded from this discussion of credit cards.

23. Board of Governors of the Federal Reserve System, *Consumer Credit*, Statistical Release G.19, January 2013.
24. Amy Traub and Catherine Ruetschlin, *The Plastic Safety Net: Findings from the 2012 National Survey on Credit Card Debt of Low- and Middle-Income Householders*, www.demos.org, 2012.
25. BCS Alliance, *Credit Card Profits*, http://www.bcsalliance.com/creditcard_profits.html.
26. Public Law Number 111-24, 123, *United States Statutes at Large*, 1734.
27. Board of Governors of the Federal Reserve System, *Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions*, June 2012.
28. Interview with Shailesh Mehta, former CEO of Providian, Frontline, *The Card Game*, 2009, http://www.pbs.org/wgbh/pages/frontline/creditcards/etc/script.html.
29. Joshua M. Frank, *Dodging Reform: As Some Credit Card Abuses are Outlawed, New Ones Proliferate*, Center for Responsible Lending, December 10, 2009. See also Sha Yang, Livia Markoczy, and Min Qi, "Unrealistic Optimism in Consumer Credit Card Adoption," *Journal of Economic Psychology*, 28 (2007), 170–185.
30. Connie Prater, "U.S. Credit Card Agreements Unreadable to 4 Out of 5 Adults: Contracts Written at a Reading Level Most Can't Understand," Creditcards.com, July 22, 2010, http://www.creditcards.com/credit card-news/credit card-agreement-readability-1282.php.
31. See Robert D. Manning, *Credit Card Nation: The Consequences of America's Addiction to Credit* (New York: Basic Books, 2000).
32. For analyses of the CARD Act, see Jim Hawkins, "The CARD Act on Campus," *Washington and Lee Law Review*, 69 (2012), 1471–1534; Kathryn A. Wood, "Credit Card Accountability, Responsibility and Disclosure Act of 2009: Protecting Young Consumers or Impinging on Their Financial Freedom?" *Brooklyn Journal of Corporate, Financial and Commercial Law*, 5 (2010–2011), 159–183; Regina L. Hinson, "Credit Card Reform Goes to College," *North Carolina Banking Institute*, 14 (2010), 287–308.
33. Haiyang Chen and Ronald P. Volpe, "An Analysis of Personal Financial Literacy Among College Students," *Financial Services Review*, 7 (1998), 107–128; James A. Roberts and Eli Jones, "Money Attitudes, Credit Card Use, and Compulsive Buying Among American College Students," *Journal of Consumer Affairs*, 35 (2001), 213–240; Jacquelyn Warwick and Phylis Mansfield, "Credit Card Consumers: College Students' Knowledge and Attitude," *Journal of Consumer Marketing*, 17 (2000), 617–626.
34. The Federal Reserve Board clarified the CARD Act in Regulation Z, which states that students may use any income or assets to demonstrate ability to repay and that they need only the ability to pay the minimum amount due. Furthermore, the obligation of a cosigner extends only until the student's twenty-first birthday. *Code of Federal Regulations* §226.51 (2012).
35. Creola Johnson, "Maxed Out College Students: A Call to Limit Credit Card Solicitation on College Campuses," *Legislation and Public Policy*, 8 (2005), 191–277, 191–192.

36. Johnson, "Maxed Out College Students", p. 193.
37. Jill M. Norvilitis, P. Bernard Szablicki, and Sandy D. Wilson, "Factors Influencing Levels of Credit Card Debt in College Students," *Journal of Applied Social Psychology*, 33 (2003), 935–947, 941.
38. Wood, "Credit Card Accountability, Responsibility and Disclosure Act of 2009," p. 163.
39. Warwick and Mansfield, "Credit Card Consumers," p. 623.
40. Angela C. Lyons, "A Profile of Financially At-Risk College Students," *Journal of Consumer Affairs*, 38 (2004), 56–80, 63; and Norvilitis, Szablicki, and Wilson, "Factors Influencing Levels of Credit Card Debt in College Students," p. 941.
41. Manning, *Credit Card Nation*, p. 162.
42. Roberts and Jones, "Money Attitudes, Credit Card Use, and Compulsive Buying Among American College Students," p. 234.
43. Hawkins, "The CARD Act on Campus," pp. 1504–1505.
44. In Re: Checking Account Overdrafting Litigation, United State District Court, Southern District of Florida, Miami Division, Case No. 1:09-MD-02036-JLK.
45. Beth Healy and Todd Wallack, "Citizens in $137.5 M Overdraft Settlement," *Boston Globe*, April 25, 2012.
46. For examples, see Joshua M. Frank, *Dodging Reform: As Some Credit Card Abuses Are Outlawed, New Ones Proliferate*, Center for Responsible Lending, December 10, 2009.
47. Neil Stewart, "The Cost of Anchoring on Credit Card Minimum Repayments," *Psychological Science*, 20:1 (2009), 39–41.
48. Federal Deposit Insurance Corporation, *FDIC Study of Bank Overdraft Programs*, November 2008.
49. Tara Siegel Bernard, "In Retreat, Bank of America Cancels Debit Card Fee," *New York Times*, November 1, 2011.
50. Carl F. Taeusch, "The Concept of 'Usury': The History of an Idea," *Journal of the History of Ideas*, 3 (1942), 291–318.
51. Max Weber, *The Protestant Ethic and the Spirit of Capitalism*, trans. Talcott Parsons (London: Unwin University Books, 1968 [first published in 1930]); and R. H. Tawney, *Religion and the Rise of Capitalism: A Historical Study* (New York: Harcourt Brace and Company, 1926).
52. *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).
53. *Smiley v. Citibank*, 517 U.S. 735 (1996).
54. For further development of these arguments, see Vincent D. Rougeau, "Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates," *University of Colorado Law Review*, 67 (1996), 1–46.
55. The Omnibus Budget Reconciliation Act of 1993 added Section 162(m) to the Internal Revenue Code, which removed the unrestricted tax deductibility of salary compensation over $1 million. Critics charge that the main effect of this legislation was to make $1 million the base pay for CEOs and to encourage the use of stock options as an alternative to cash compensation, thereby exacerbating the problem of high executive compensation. See Nancy L. Rose and Catherine

Wolfram, "Has the 'Million Dollar Cap' Affected CEO Pay?" *American Economic Review*, 90 (2000): 197–202; and Brian J. Hall and Jeffrey B. Liebman, "The Taxation of Executive Compensation," in James Poterba (ed.), *Tax Policy and the Economy*, vol. 14 (Cambridge: NBER & MIT Press, 2000).

56. "The Economic Effects of Proposed Ceilings on Credit Card Interest Rates," *Federal Reserve Bulletin*, 73 (January 1987), 1–13.
57. Todd J. Zywicki, "The Economics of Credit Cards," *Chapman Law Review*, 3 (2000), 79–172.
58. Lawrence M. Ausubel, "The Failure of Competition in the Credit Card Market," *American Economic Review*, 81 (1991), 50–81. The period under study was 1983–1988.
59. Thomas F. Cargill and Jeanne Wendel, "Bank Credit Cards: Consumer Irrationality versus Market Forces," *Journal of Consumer Affairs*, 30 (1996), 373–389. See also Glenn B. Canner and Charles A. Luckett, "Developments in the Pricing of Credit Card Services," *Federal Reserve Bulletin*, 78 (1992), 652–666; and Zywicki, "The Economics of Credit Cards."
60. Angela Littwin, "Beyond Usury: A Study of Credit Card Use and Preference among Low-Income Consumers," *Harvard Law School Faculty Scholarship Series*, Paper 8 (2007); and Angela Littwin, "Testing the Substitution Hypothesis: Would Credit Card Regulation Force Low-Income Borrowers into Less Desirable Lending Opportunities?" *University of Illinois Law Review*, 2009 (2009), 403–455.
61. *National Commission on Consumer Finance, Report on Consumer Credit in the United States* (1972), p. 149.
62. Information on Lehman Brothers and First Alliance is taken from Monte Morin, "Lehman Disputes Charges about First Alliance," *Los Angeles Times*, February 19, 2003; E. Scott Reckard, "Lehman Aided Lender's Fraud," *Los Angeles Times*, May 9, 2003; E. Scott Reckard, "Lehman Bros. Held Liable in Fraud Case," *Los Angeles Times*, June 17, 2003; Diana B. Henriques, "Lehman Aided in Loan Fraud," *New York Times*, June 17, 2003; and Michael Hudson, "Lending Hand: How Wall Street Stoked the Mortgage Meltdown," *Wall Street Journal*, June 27, 2007.
63. *Financial Crisis Inquiry Commission Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Washington, DC, January 2011), p. 70.
64. Kristopher Gerardi, Harvey S. Rosen, and Paul Willen, "Do Households Benefit from Financial Deregulation and Innovation? The Case of the Mortgage Market," *National Bureau of Economic Research, Working Paper* 12967, March 2007.
65. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, "Subprime Lending: Expanded Guidelines for Subprime Lending Programs," June 12, 2000.
66. See Edmund L. Andrews, "Fed Shrugged as Subprime Crisis Spread," *New York Times*, December 18, 2007; and Binyamin Appelbaum, "As Subprime Lending

Crisis Unfolded, Watchdog Fed Didn't Bother Barking," *Washington Post*, September 27, 2009.

67. Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages," Federal Reserve Bank of Kansas City, *Economic Review*, Fourth Quarter 2007, pp. 105–113, 109.
68. Securities and Exchange Commission, "Excerpts of E-Mails from Angelo Mozilo," at http://www.sec.gov/news/press/2009/2009-129-email.htm.
69. The full text is: The 100% loan-to-value subprime product is "the most dangerous product in existence and there can be nothing more toxic and therefore requires that no deviation from guidelines be permitted irrespective of the circumstances."
70. "Nightmare Mortgages," *Bloomberg Businessweek Magazine*, September 10, 2006.
71. For a fuller discussion, see Robert W. Kolb, "Incentives in the Financial Crisis of Our Time," *Journal of Economic Asymmetries*, 7 (2010), 21–55.
72. Kolb, "Incentives in the Financial Crisis of Our Time," p. 29.
73. Jeff Swiatek, "Mortgage Brokers Are Becoming a Vanishing Breed," *USA Today*, August 29, 2010.
74. This is argued in Brent T. White, "Underwater and Not Walking Away: Shame, Fear, and the Social Management of the Housing Crisis," *Wake Forest Law Review*, 45 (2010), 971–1023.
75. "The Morality of Jingle Mail: Moral Myths about Strategic Default," *Wake Forest Law Review*, 46 (2011), 123–153.
76. "Arbitration Task Force Issues 70 Recommendations in Largest Revamping of Securities Arbitration Since Its Start More than a Century Ago," NASD Press Release, January 22, 1996.
77. Rep. Edward J. Markey of Massachusetts, quoted in Shirley Hobbs Scheibla, "See You in Court," *Barron's*, June 5, 1989.
78. 482 U.S. 220 (1987), cert. denied 483 U.S. 1056 (1987).
79. *Securities Arbitration Reform: Report of the Arbitration Policy Task Force*, January 1996, p. 15.
80. Margaret A. Jacobs and Michael Siconfolfi, "Investors Fare Poorly Fighting Wall Street–And May Do Worse," *Wall Street Journal*, February 8, 1995. The quotation from the *Wall Street Journal* is a paraphrase of the speaker's words.
81. NASD Press Release, January 22, 1996.
82. *Securities Arbitration Reform*, 88.
83. *Securities Arbitration Reform*, 10.
84. *Securities Arbitration Reform*, 45.
85. Michael Schroeder, "Wall Street Should Stop Playing the Bully," *BusinessWeek*, December 20, 1993.