Justice for All?

How Inequality is Eroding the Rule of Law

by Joseph E. Stiglitz

Editor’s Note: In 2011, Professor Joseph Stiglitz, noted economist, wrote an article for Vanity Fair magazine entitled, “Of the 1%, by the 1%, for the 1%.” The term was picked up in a rallying cry to the Occupy Wall Street movement as the U.S. working class woke up to the fact that they had been robbed. The rating class by Wall Street financial institutions — of their houses, their credit rating, their ability to borrow money and finally their jobs. While the Occupy movement was quickly smashed by the various local and state governments working in tandem, the consciousness that something is definitely wrong in the state of the United States continues to resonate. Meanwhile, the 2008 financial disaster has resulted in the making of fortunes. In this excerpt from Professor Stiglitz’ book The Price of Inequality, he details one aspect of the process that has led to the marginalization of the working class in the United States.

Predatory Lending

Early on in the housing bubble, it became clear that the banks were engaged not only in reckless lending — so reckless that it would endanger the entire economic system — but also in predatory lending, taking advantage of the least educated and financially unsophisticated in our society by selling them costly mortgages and hiding details of the fees in fine print incomprehensible to most people. Some states tried to do something about it. For instance, in October 2002 the Georgia legislature, after observing that mortgage lending in the state was riddled with fraud and predation, tried to call a halt to it with a consumer protection law. The response from the financial markets was quick and intense.

The ratings agencies, today best known for their role in calling pools of F-rated mortgages A-rated securities, also had a hand in sustaining fraudulent lending practices. They should have welcomed the actions of states like Georgia: the law meant that the agencies would not need to assess whether mortgages in a given pool were fraudulent or inappropriate. Instead, Standard & Poor’s, one of the leading rating agencies, threatened not to rate any of Georgia’s mortgages. Without these ratings, the mortgages would have been hard to securitize and without securitization (in the business model of the day) mortgage lending in the state might dry up. Evidently, the rating agencies were worried that if the practice spread to other states, the flow of bad mortgages from which they made so much money “rating” would be greatly diminished. S&P’s threat was effective: the state quickly reversed the law.

In other states, too, there were attempts to stomp predatory lending, and in each of these instances banks used all their political muscle to stop states from enacting laws aimed at curtailing predatory lending. The result, as we know now, was not only massive fraud but also bad lending: too much indebtedness, with financial products that could explode with a change in interest rates or in the broader economic conditions, and indeed many did explode. In a simpler world, the adage (“Let the buyer beware”) might have been appropriate; but not in today’s complex world. A regulatory agency for financial products is needed to prevent not just fraud but also abusive, deceptive, and inappropriate products. Even many financial institutions recognized that some regulation was needed: without bank and insurance regulations ensuring the soundness of these institutions, individuals would be reluctant to turn over their money to banks and insurance companies, lest they never get it back. Individuals on their own would never be able to assess the financial conditions of these large and complex institutions; it has proven hard enough for experienced government regulators to do so.

But the U.S. banking sector resisted the suggestion that regulation be extended to protect consumers, in spite of its terrible record of bad lending and poor credit practices before the crisis, which had led to widespread public support for an agency to do so. And when a provision creating such an agency was included in the Dodd-Frank bill, financial institutions campaigned to make sure that Elizabeth Warren, a Harvard law professor with all the credentials necessary to run such an agency, including the expertise and commitment to protect consumers, was not chosen to head it. The banks won. (She was, in fact, widely cited as the originator of the idea of such an agency, and a tireless campaigner for it, a sin for which the financial community could not forgive her. Even worse, she served as chair of the Congressional Oversight Panel, overseeing the government’s bailout program. The panel revealed that the administration was...
giving the banks a great deal — getting back from the banks preferred shares worth about half of what the government was giving them."

Bankruptcy Law

A host of other laws and regulations shape the market and thereby affect the ability of individuals to manage their income and well-being. Bankruptcy law (which specifies what happens when an individual or a corporation can't pay back what it owes) has particular relevance to two parts of our society — those at the top (the bankers) and those at the bottom, who struggle to make ends meet.

Bankruptcy law is designed to give individuals a fresh start. The notion that under certain conditions debts should be forgiven has a long tradition that goes back at least as far as the Book of Leviticus, where debts were forgiven in the Jubilee year. Virtually every modern economy has a bankruptcy law. These laws can be either more debtor or more creditor friendly, making it easier or more difficult to discharge debts and to foreclose on their assets. They have shaped obviously has strong distributional consequences, but the incentive effects can be equally powerful. If debts can't be discharged, or can be discharged easily, lenders have less incentive to be careful in lending — and more of an incentive to engage in predatory lending.

In 2005, just as subprime mortgages were starting to boom, Congress passed a law that loosened bankruptcy law that gave the banks more even of an upper hand, making it more difficult for distressed borrowers to discharge their debts. The change in the law introduced a system of "partial involuntary servitude." An individual with, say, debts equal to 100 percent of his income could be forced to hand over to the bank 25 percent of his gross, pretax income for the rest of his life. This is because the banks could add on, say, 30 percent interest each year to what a person owed. In the end, a mortgage holder would owe far more than the bank ever lent. The debtor would end up working, in effect, one-quarter time for the bank.

Every loan has a willing lender and a willing borrower; the banks are supposed to be financially sophisticated, to know how much debt individuals can manage. But a distorted financial system put more emphasis on the up-front fees that showed up quickly in the banks' bottom line than on the losses that might be incurred further down the line. Emboldened by the new bankruptcy law, they felt they could somehow squeeze money out of their hapless borrowers, whatever happened to the housing market and unemployment.

This reckless lending, combined with deceptive practices and sometimes usurious interest rates, has put many households on the brink of financial ruin. In spite of so-called reforms, banks still sometimes charge rates near 30 percent a year (which means that a $100 debt can grow to $1,000 in a short span of nine years). On top of this, they can impose crippling fees. While some of the worst abuses have been curbed, such as those associated with overdrafts (which generated literally billions of dollars a year in profits — money taken out of the pockets of ordinary citizens), many continue.

When the new bankruptcy law was passed, property rights were changed, but in a way that favored the interests of the banks. At the time, the banks were saying their debt, a more humane bankruptcy law gave them a chance for a fresh start if the burden of debt repayment became too onerous. The banks didn't complain about this change in property rights after all, they had pushed for it vociferously. When things go the other way, of course, the owners of property complain that the rules of the game allowing changed course and demand compensation.

1. For a discussion, see G. Morgenroth and Joshua Rosner, Real Estate Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon (New York Times Books, 2013). More specifically, the ratings agencies claimed that they could not rate RMBS based on mortgages originated in New Jersey and Georgia, on the grounds that the RMBS holder would be liable under state Consumer Protection or Predatory Lending Law. Under the Georgia law, unlimited punitive damages for predatory lending under the Georgia Fair Lending Act would extend to RMBS backed by loans secured in the amendment of the Georgia Protection Lending statute in 2003. A similar chain of events happened in connection with the amendment of the New Jersey Homeownership Security Act of 2002 to impose lenders in June 2004.

2. One of the most important additional aspects was the preemption by federal bank regulators, notably the Office of the Controller of the Currency (OCC), which is the agency in the Treasury charged with overseeing banks, and FTC (the Office of Thrift Supervision, originally set up to oversee the savings and loans institutions), of stricter state regulation by claiming jurisdiction over national banks. The federal regulators used their titanic magnitude to protect banks in its state more strictly, the tighter standards would extend only to state-chartered banks, which would then be less competitive than the nationally chartered institutions. Making matters worse, "some states, such as Georgia, have parity or wild cards that exempt state-chartered banks from and their subsidiaries from state anti-predatory lending laws to the same extent as national banks and federal thrifts." P. McCoy and E. Reutter, "The Legal Infrastructure of Subprime and NonTraditional Home Mortgages," Joint Center for Housing Studies Harvard University, UCBB-9. The head of the OCC tried to allay the Congressman's misgivings about their preemption. "Our approach . . . protects consumers whose abusive practices are found.

3. See my "Foreword" (New York: Norton, 2010) for a fuller discussion of the whole variety of bad financial products and the consequences.

4. Just as the Food and Drug Administration protects consumers against deceptive, dangerous, and ineffective drugs.

5. More robust, of course, if they happen to be European regulators supervising the banks in a country near- or in line with what we would do in adverse conditions—and it passed brilliantly, the bank collapsed. Private rating agencies, too, have demonstrated that they are not up to the task.

6. In the first set of deals, taxpayers got back about 65 cents on the dollar in the later deals, especially with AIG and Citibank, they got back about 41 cents on the dollar. See Congressional Oversight Panel, "Vilifying Treasury's Acquisitions," February Oversight Report, Page 14. 20 of the 24 banks involved against ordinary citizens, the magnitude of the banks' bad behavior was so large that there was some accountability — though not enough to offset the huge profits they had made in their predatory lending, which was often targeted at poor African Americans and Hispanics. See chapter 3 for a more extensive discussion.

7. While many mortgages were nonrecourse (that is, creditors could claim only the money they could get from the borrower's other assets), and thus might not be affected by this provision, most of the subprime lending involved second mortgages, which were recourse. The change in the bankruptcy law applied to each loan.

8. Overdraft fees average between $33 and $55 a transaction and have risen by almost a fifth over the past five years. In 2011 they were estimated to increase bank earnings by $30 billion. Ninety percent of the fees are paid by 10 percent of the customers, mostly low income. The attempt to vote in 2010 failed partly because customers were misled by the banks. The director of the new consumer agency, Richard Cordray, criticized bank practices designed to ensure that customers did not understand the fees they faced.

9. They call it a regulatory tax. But any change in law that affects contracts or property has redistributive consequences.

Excerpted from The Price of Inequality: How Today's Divided Society Endangers Our Future by Joseph E. Stiglitz © 2013 by Joseph E. Stiglitz. With permission of the Publisher, W.W. Norton & Company, Inc. All rights reserved.

Editor's Afterword: On September 18, 2015, United Nations delegates from 193 nations, including the United States, adopted a resolution outlining the Sustainable Development Goals for the coming fifteen years. Their focus was to "end poverty in all its forms and dimensions, including extreme poverty, slum conditions and an inadequate level of sustainable development."

To achieve that goal one of the specific Sustainable Development Goals calls on member states to "provide access to justice for all and build effective, accountable and inclusive institutions at all levels."

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The goal includes as one of its targets to:

Promote the rule of law at national and international levels and ensure equal access to justice for all.

The U.S. media has virtually blacked out any reporting on this monumental decision by the world leaders or the fact that each country agreed to take the Sustainable Development Goals to their legislative bodies to develop plans of implementation. Hence, there has been no discussion of how the United States is going to meet these goals or to involve the population in determining a way forward.

Professor Stiglitz, excerpt from his book "The Price of Inequality"

Keep up the good work, CCLP!

from

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