briefing paper

RISKING OUR FUTURE MIDDLE CLASS: Young Americans Need Financial Reform

Young adults have an enormous stake in the financial regulatory reform debate. They have paid a high price for a banking crisis caused by lax regulation, and their economic futures will depend on rebuilding strong public structures for financial regulation going forward. This briefing paper addresses some of the key reforms and the impact of both the banking crisis and unregulated lending practices on young Americans' financial futures.

The Deregulatory Roots of the Financial Crisis

Today's young adults have come of age during an era when anti-regulation ideology has held sway in Washington and on Wall Street. Over the past thirty years, government officials have steadily dismantled key financial sector protections that together were responsible for the longest financial crisis-free period in America's history. As a result of this trend away from regulation, complex financial products such as nontraditional mortgages and exotic derivatives flourished in the consumer and investor markets, creating record profits and bonuses for financial insiders—but putting our economy at tremendous risk.

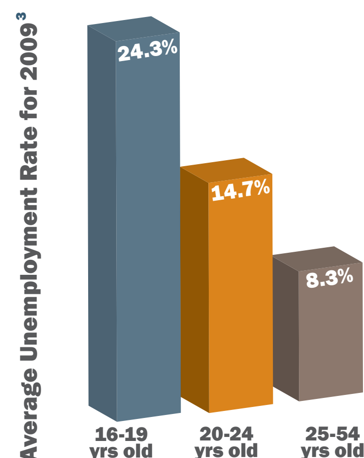
The subprime mortgage crisis began in the early 1990s when unregulated predatory lenders targeted working-class communities. It spread in the 2000s as lenders discovered the profitability of pushing complex mortgages across the market. The crisis went global as regulatory changes in the late 1990s allowed the same financial giants that were funding risky home loans to flood the market with hundreds of trillions of dollars in derivatives—essentially, bets on risk. A weakening of our public regulatory structure allowed for each of these developments.

Young Americans and the Financial Crisis

The result of this failed experiment in deregulation was a financial meltdown that has cost Americans $11 trillion in family wealth, $14 trillion in taxpayer bailouts and over 8 million jobs. Yet even before the crisis hit Wall Street, deregulated lending practices created a crisis on Main Street, with sharp increases in Americans of all ages facing high debt payments, bankruptcies and foreclosures over the past 20 years. Young Americans in particular, however, can expect lasting damage from both the financial sector crisis and the personal finance crisis in the areas of jobs, education, and indebtedness.

Jobs:

The widely-reported jobs crisis during the Great Recession has hit Depression-era levels for America's young adults. Fully 37 percent of 18– to 29-year-olds are unemployed or involuntarily out of the workforce, the highest share among this age group in more than three decades.[1] Such a bad start can have a lasting impact. A recent study shows that even fifteen years after college graduation, wages are still lower for those who entered the labor market when unemployment was high.[2]



Education:

With jobs scarce, continued education should be a refuge for young workers. Unfortunately, the decades-long disinvestment in higher education funding has left states unable to support school systems just when students are in the greatest need of aid. The financial crisis has also created a fiscal crisis in the states, resulting in further dramatic cuts to education funding. In the face of plummeting tax revenues, at least 39 states have implemented cuts to public colleges and universities and/or made large increases in college tuition to make up for insufficient state funding.[4] For example, the Arizona Board of Regents approved statewide tuition increases for 2010–11 that will raise tuition at Arizona State University nearly 20 percent overall for incoming students and about 13 percent for continuing in-state students.[5] The decision by the University of California Board of Regents to increase student fees by 32 percent was met with angry protests by students.[6]

Debt:

Young Americans have come of financial age in an era of abundant but expensive credit thanks to deregulation of consumer financial services over the past 20 years. As students, workers and young parents, this generation faces the difficult combination of low wages and benefits, high costs and high debt levels. Debt has become a generation-defining characteristic for today's young adults.

- **Credit cards:** Today's 20–and 30–somethings are relying more on credit cards to cover basic living expenses, particularly during those first few years in the workplace. Roughly half of households headed by someone under 35 carry a credit card balance.[7] In recent years, credit card companies have made common use of gotcha tactics like jacking up interest rates at any time for any reason, charging interest this month for last month's balances, and applying payments to the lowest-interest balance first to maximize finance charges. Congress has enacted legislation to ban a number of these outrageous tactics—the new law also puts curbs on soliciting borrowers under 21 and colluding with universities to market to students—but credit card lenders have already begun to alter contracts to get around the new rules.
- **Private student loans:** Graduates with onerous debt find their career options constrained and their ability to save for basic needs such as retirement and the creation of a family greatly undermined by debt payments. Indeed, 20 percent of students who take out loans do not graduate, leaving them without the benefit of a college degree and with the burden of a student loan.[8] This burden is especially heavy for those who take out private (nonfederal) student loans, which are generally more expensive and offer few borrower protections in comparison to federal student loans. With variable interest rates as high as 19 percent in recent years, private loans can be as expensive and ill-advised as putting tuition on a credit card.[9] Still, due to aggressive marketing and a lack of regulation, nearly 3 million American students took out private loans in 2007–08, up from less than 1 million just four years earlier.[10] America's students have taken out $120 billion in private loans over the past decade.[11] Between 2003–04 and 2007–08, the percentage of African-American undergraduates who took out private loans quadrupled from 4 percent to 17 percent, making them the most likely group to take out pricey, dangerous private loans.[12]
- **Mortgages:** The housing bubble drove the price of the quintessential "starter home" out of reach for millions of young adults. Nationally, housing prices nearly doubled from January of 2000 to the summer of 2006.[13] The 37 percent of young adults who went into debt to afford a home[14], however, were as vulnerable as other Americans to the deceptive and abusive mortgage lending practices that flourished due to poor regulation.

- **Auto Loans:** In most parts of the country, a car is an essential purchase—and for young people, the highest-priced asset they own. Forty-one percent of younger households have auto loans.[15] However, the auto lending market is plagued by well-documented deceptive practices. Today, a majority of auto dealer profits are derived not from the car itself, but rather from the financing and add-ons in car sale transactions.[16] Consequently, dealers often engage in deceptive practices such as falsification of loan applications, discretionary interest rate markups and bait-and switch (or "yo-yo") financing where the dealer promises one rate but ultimately charges a much higher rate. Yo-yo financing impacts an estimated 1 in 4 borrowers with incomes below $25,000, costing borrowers an average of 5 percent higher interest on their car loans.[17] Dealer markups cost consumers $20 billion every year.[18]

The Solution: Strong Financial Reform for a Strong Future Middle Class

Young adults are paying a stiff price for the economic havoc wreaked by Wall Street. The thirty-year campaign against even the most basic forms of government regulation has drastically dismantled the rules that once ensured dynamic, competitive financial markets. A return to economic stability and accountability is important for young people not only for their immediate economic livelihood but to guarantee that America has a future middle class.

Consumer Financial Protection

The proposed Consumer Financial Protection Agency will be the public structure that helps guarantee fair and transparent loans for young adults' schooling, first homes and business ventures. These tools are essential for young adults establishing their independence and starting a family. But getting on your feet can be a treacherous climb when the tools you rely on have been designed to drag you down.

Restoring basic fairness to consumer finance is critical for the next generation of savers and homeowners. The financial reform legislation before Congress would create a Consumer Financial Protection Agency (CFPA), a new watchdog that would be the first government entity whose primary mission is to protect the economic wellbeing of ordinary Americans. The CFPA would have jurisdiction to block deceptive credit card terms, require student lenders to follow fair rules of the road, require mortgage brokers to take steps to offer borrowers loans they can afford, and let first-time car buyers put their money toward vehicles instead of excessive interest rate payments.

Young people also deserve a strong, independent Consumer Financial Protection Agency that is responsible for setting and enforcing clear rules across the financial marketplace. Congress must be careful not to undermine the independence of the consumer protection agency, or to exclude from its oversight any purveyor of financial products. If Congress enacts a strong Consumer Financial Protection Agency, young Americans stand to benefit from more disclosure and fairer pricing.

Safeguarding the Financial Sector from Excessive Risk-Taking

In order to pave the way to economic security for the next generation, we need to establish integrity in the financial markets and facilitate productive economic activity that benefits all segments of our communities. The financial sector is supposed to be the economic engine that drives the creation of good jobs for new entrants to the workplace, supports security in saving for a home or retirement, provides the goods and services that young people need and want, and is sustainable over the long-term.

The current financial crisis is the natural and logical result of a failed financial regulatory system that placed an irrational faith in the ability of markets to self-correct. As a result, regulators ignored repeated warnings about the amount and types of risk being taken on by financial institutions and the general movement of financial activity into increasingly complex and opaque forms. New reforms must give bank regulators the ability to identify and cure risks that could threaten the broader financial system. Central to that goal is bringing the activity of the unregulated "shadow markets" into the light. Complex financial products like derivatives are traded in secret instead of in an open market like the stock market, hiding the scope of the associated risk. The derivatives market is more than 30 times U.S. GDP, and more than 8 times the size of the "regular" credit markets.[19] As long as derivatives are unregulated, the bulk of our financial system is unregulated. Equally important is the authority to manage the failures of large institutions in a way that neither disrupts the entire economy nor requires the massive infusion of taxpayer dollars we saw in the recent bailouts.

The financial meltdown has shown us that incentive structures on Wall Street encouraged excessive speculation and short-term executive payouts over long-term growth and stability. Even worse, the ability of both federal overseers and shareholders to influence bank practices has been depleted. A reinvigorated Securities and Exchange Commission, equipped to fully carry out its mission of oversight of the markets and financial professionals, is needed to protect the interests of investors at every level. As owners of publicly traded companies, shareholders must be given an active role in the election of corporate boards and establishment of compensation policy, as well as the legal means to take action against financial fraud and abuse.

Conclusion

Legislation to overhaul the financial sector faces fierce opposition from banking industry lobbyists and the powerful U.S. Chamber of Commerce. But America's young people deserve clear rules and strong enforcement. New policies must work to maximize the potential for young people–especially for those from less advantaged financial backgrounds and young people of color–to complete their educations, obtain decent jobs when they enter the labor market, and to save and build assets for the future.

It should be our shared responsibility to help America's youth build a strong foundation for the future. That means creating the regulatory framework that brings transparency and accountability to financial markets and enables us to foresee and manage future crises. As taxpayers and future stewards of the national debt, young Americans have a keen interest in avoiding multi-trillion-dollar bailouts to cover the irresponsibility of our largest banks and financial institutions. We cannot wait any longer for real financial reform.

Endnotes

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