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Consumer Protection Out of the Shadows of Shadow Banking: The Role of the Consumer Financial Protection Bureau

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CONSUMER PROTECTION OUT OF THE SHADOWS OF SHADOW BANKING: THE ROLE OF THE CONSUMER FINANCIAL PROTECTION BUREAU

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Consumer protection remains the stepchild of financial regulation. Notwithstanding the fact that the economic doldrums we find ourselves in originated in the under-regulated subprime mortgage sector, relatively few academic commentators focus on the role that consumer protection can play in reducing such risks as well as in restoring the balance between consumer and producer in the financial markets. This essay suggests that consumer protection regulation has an important role to play in the regulatory structure of the shadow banking sector.

This essay does four things. First, it describes the role of shadow banking in the residential mortgage market—the shadow mortgage banking sector, as it were. Second, it contrasts two mortgages: one is emblematic of shadow mortgage banking during the Subprime Boom and the other is Dodd-Frank's response to the excesses of the Subprime Boom—the "Qualified Mortgage." It then evaluates whether Qualified Mortgages can restrain some of shadow mortgage banking's excesses, and finds that they may be able to do so. It concludes by reviewing the first steps taken by the Consumer Financial Protection Bureau as it begins implementing Dodd-Frank's mortgage-related provisions.

I. SHADOW MORTGAGE BANKING

The shadow mortgage banking system dwarfs the banking system's role in the residential mortgage markets.[1] A key component of the shadow banking[2] system is the securitization of credit,[3] particularly of residential

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1. Erik F. Gerding, The Shadow Banking System and its Legal Origins 31 (Aug. 23, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1990816.

2. I use here Professor Schwarcz's broad definition of shadow banks: "non-banks [that] provide financial products and services." Steven L. Schwarcz, *Regulating Shadow Banking*, 31 REV. BANKING & FIN. L. 619, 621 (2012). Others prefer more limited definitions. *See, e.g.*, Zoltan Pozsar, et al., *Shadow Banking*, 2012 FED. RESERVE BANK OF N.Y. STAFF REPORT No. 458, at abstract, *available at* http://www.ny.frb.org/research/staff_reports/sr458.pdf (defining shadow banks as "financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees") (Staff Report No. 458); Bernard S. Sharfman, *Using the Law to Reduce Systemic Risk*, 36 J. CORP. L. 607, 609 n.8 (2011) (defining shadow banking as "unregulated financial intermediation" (quoting Alessio M.

mortgages.[4] However, shadow banking institutions that originated residential mortgages, particularly subprime mortgages, were much less regulated than banking institutions that had the same line of business.[5] As a result, they were less constrained by consumer protection regulations.[6] They were also able to lower their underwriting standards in order to increase their market share.[7]

This weaker underwriting could be seen in the proliferation of exotic mortgage products that

> (i) did not require a down payment;
>
> (ii) allowed for negative amortization;[8] and
>
> (iii) had no-doc verification of income and assets for underwriting purposes—the notorious "liar loan."[9]

These exotic mortgages allowed lenders to lend to many borrowers who did not have the credit profile of the traditional prime borrower.[10]

Secondary market shadow bankers encouraged this phenomenon partially because a bigger consumer pipeline meant more mortgage-backed

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Pacces, The Role and the Future of Regulation in the Financial Crisis: The Uncertainty Perspective 6 (Feb. 8, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1551266)).

3. Schwarcz, *supra* note 2, at 622 n.12 ("[A] large part of what is considered in today's markets to be structured finance involves securitization." (quoting Henry A. Davis, *The Definition of Structured Finance: Results from a Survey*, 11 J. STRUCTURED FIN. 5, 7 (2005) (internal quotation marks omitted)).

4. *See* Tobias Adrian, *Dodd-Frank One Year on: Implications of Shadow Banking*, 2011 FED. RESERVE BANK OF N.Y. STAFF REPORT No. 533, 1, *available at* http://www.newyorkfed.org/research/staff_reports/sr533.pdf.

5. *See* David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 997 (2006) [hereinafter Reiss, *Subprime Standardization*]; *see also* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2010, at 261, 261.

6. *See* Reiss, *Subprime Standardization*, *supra* note 5, at 997; *see also* Gorton & Metrick, *supra* note 5, at 261; Jason Hsu & Max Moroz, *Shadow Banks and the Financial Crisis of 2007–2008*, *in* THE BANKING CRISIS HANDBOOK 39, 45 (Greg N. Gregoriou ed., 2010). Additionally, the Financial Crisis Inquiry Commission found that shadow banking includes many "bank-like financial activities that are conducted outside the traditional commercial banking system, many of which are unregulated or lightly regulated." Schwarcz, *supra* note 2, at 623 (quoting FINANCIAL CRISIS INQUIRY COMMISSION, PRELIMINARY STAFF REPORT: SHADOW BANKING AND THE FINANCIAL CRISIS 7 (May 4, 2010), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0505-Shadow-Banking.pdf).

7. *See* Adam J. Levitin et al., *The Dodd-Frank Act and Housing Finance: Can It Restore Private Risk Capital to the Securitization Market?*, 29 YALE J. ON REG. 155, 158 (2012).

8. ADRIAN, *supra* note 4. "'Negative amortization' refers to loans for which the principal amount of the loan increases . . . over the term of the loan" despite timely payments by the borrower. Reiss, *Subprime Standardization*, *supra* note 5, at 1027.

9. KATHLEEN ENGEL & PATRICIA MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 36 (2011).

10. *See* Gerding, *supra* note 1, at 30.

securities underwriting and, thus, more fees.[11] But they also encouraged looser underwriting standards because subprime mortgages could generate higher profits than comparable prime mortgages due to their significantly higher interest rates and more opaque pricing.[12]

During the early 2000s, the shadow mortgage banking sector appeared to excel at providing inexpensive funding by taking illiquid and, in some cases, risky and confusing individual mortgages and converting them into liquid, investment grade, fungible securities.[13] But while the shadow mortgage banking sector appeared to convert illiquid mortgages into liquid investments, it in fact did the opposite by "fund[ing] illiquid assets with short-term liabilities," creating a liquidity mismatch that is exposed to runs in the commercial paper and other short-term lending markets, much like the bank runs of earlier eras.[14] Because that process of securitization was built on a faulty foundation, it contributed in no small part to the Subprime Boom and Bust.[15]

The systemic problem with the subprime sector's origination practices was not just that they were originating mortgages that were more likely to default.[16] Underwriting standards for securitized pools can address this concern if the higher rates of default are predictable.[17] The thornier problem, from a mortgage-backed securities underwriting perspective, is that market participants did not understand how risky those mortgages were and how rapidly the risk profile of mortgage products originated by many shadow banking institutions changed.[18] In other words, underwriters and

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11. *See* Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1366–67 (2009).

12. Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 126, 140–43 (2007).

13. POZSAR ET AL., *supra* note 2, at 11–12.

14. Hsu & Moroz, *supra* note 6, at 45. A "bank run" occurs when a bank's depositors withdraw their deposits from a bank because they fear it is insolvent. *Id.* at 42–43. Because banks keep only a small percentage of their deposits on hand, a bank run can ruin even a healthy bank. *See* Fred Galves, *Might Does Not Make Right: The Call for Reform of the Federal Government's* D'Oench, Duhme *and 12 U.S.C. § 1823(e) Superpowers in Failed Bank Litigation*, 80 MINN. L. REV. 1323, 1339 n.66 (1996) (citing THE NEW PALGRAVE DICTIONARY OF MONEY AND FINANCE 171 (Peter Newman et al. eds., 1992)).

15. *See* Hsu & Moroz, *supra* note 6, at 45, 48–55 (describing the role of shadow banking in the 2008–2009 financial crisis).

16. Kristopher S. Gerardi et al., *Making Sense of the Subprime Crisis*, 2009 FED. RES. BANK OF BOS. PUB. POL'Y DISCUSSION PAPERS 09-1, 7, *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0901.pdf ("Loans originated with less than complete documentation of income or assets, and particularly those originated with both high leverage and incomplete documentation, exhibited sharper rises in defaults than other loans.").

17. *See id.* at 2 (suggesting that the ability to accurately predict rates of default would have helped to curb lax underwriting and rating standards leading up to the subprime credit boom).

18. *See* POZSAR ET AL., *supra* note 2, at 3; Schwarcz, *supra* note 2, at 632, 634–35; *see also* Tobias Adrian & Adam M. Ashcraft, *Shadow Banking Regulation*, 2012 FED. RES. BANK OF N.Y. STAFF REPORT No. 559, 7–8, *available at* http://ssrn.com/abstract=2043153 (likening the breakdown of reliable creditworthiness information to a "game of telephone" where each step of

rating agencies had no baseline from which they could establish reliable default rates for all of the new products that were originated during the Boom.[19] Many other academics have called for increased regulation of the shadow banking sector in order to ensure its stability;[20] but few have focused on the role of consumer protection regulation as part of that new foundation.[21]

II. A TALE OF TWO MORTGAGES[22]

The following tale of two mortgages provides a good context for understanding the role of consumer protection in shadow banking regulation. One of my most striking memories from the height of the subprime boom involves a phone call from a reporter for the *Wall Street Journal*. He wanted me to comment on a particular type of high interest mortgage marketed by a national lender.

The mortgage came with a two-year teaser cap on loan payments (not on the interest rate mind you—on the payments!). It also had a three-year prepayment penalty period. This can create a perfect storm for a borrower, particularly for an unsophisticated one. For once the artificially low payments of the two-year teaser period end, the borrower might find it difficult to make her payments on the loan.

The mortgage also has a prepayment penalty. If the borrower tries to refinance from this high interest rate product to a more affordable one after the two-year teaser cap is lifted, she will be forced to pay a prepayment penalty. That is because the prepayment penalty period lasts for three years, a year longer than the teaser cap on payments. This scheme ensures that the lender wins—one way or another.

Let us turn to another species of mortgage, Dodd-Frank's "Qualified Mortgage" as well as its statutory sibling, the "Qualified Residential

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the transformation process made it increasingly more difficult for investors to understand their risk exposure).

19. *See* POZSAR ET AL., *supra* note 2, at 2–3; *see also* Schwarcz, *supra* note 2, at 633.

20. *See, e.g.*, Schwarcz, *supra* note 2, at 640–42 (suggesting that regulation of shadow banking requires a holistic approach that would include several regulatory agencies coordinating to oversee banks, securities, and derivatives); Gorton & Metrick, *supra* note 5, at 284–85 (discussing how securitization, namely shadow banking, is merely another form of banking and therefore should be regulated in the same manner as bank functions).

21. *See, e.g.*, ENGEL & MCCOY, *supra* note 9, for a discussion of how consumer abuses led to the subprime crisis. See Adam Levitin, *The Consumer Financial Protection Agency* (Georgetown Law Faculty Working Papers, Research Paper No. 1447082, 2009), *available at* http://ssrn.com/abstract=1447082, for a discussion of the flaws of the pre-CFPB consumer financial protection regulatory structure. See Erik Gerding, *The Subprime Crisis and the Link Between Consumer Financial Protection and Systemic Risk*, 5 FLA. INT'L U. L. REV. 93 (2009), for a discussion of financial regulation in terms of the link between consumer protection and systemic risk.

22. This and the following section are based on my recent article for Boston University School of Law's *Shadow Banking* symposium on February 24, 2012: David Reiss, *Message in a Mortgage: What Dodd-Frank's "Qualified Mortgage" Tells Us About Ourselves*, 31 ANN. REV. BANKING & FIN. L. 717 [hereinafter Reiss, *Message in a Mortgage*].

Mortgage."[23] Dodd-Frank tries to reduce the risk of a systemic failure by regulating the quality of mortgages that are securitized by banks and shadow banks.[24] The Qualified Mortgage is one that is privileged by Dodd-Frank in order to incentivize lenders to originate them instead of other types of mortgages.[25]

The Qualified Mortgage provides lenders with a safe harbor from certain provisions of the Truth in Lending Act (TILA) as well as from Dodd-Frank's mandatory "ability to repay" underwriting standards.[26] The net effect of this component of Dodd-Frank is to create a kind of "plain

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23. *Id.* at 719–21 (footnote omitted). The definition for a "Qualified Residential Mortgage" can be no broader than the definition of a Qualified Mortgage. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1895 (2010) (codified at 15 U.S.C. § 78o-11 (2010)).

24. Dodd-Frank enacts enhanced supervision and prudential standards for nonbank financial companies for the following purpose:

> (1) PURPOSE.—In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions, the Council may make recommendations to the Board of Governors concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies supervised by the Board of Governors and large, interconnected bank holding companies, that—
>
> (A) are more stringent than those applicable to other nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and
>
> (B) increase in stringency, based on the considerations identified in subsection (b)(3).

Dodd-Frank Act § 115(a)(1), 124 Stat. at 1403 (codified at 12 U.S.C. § 5324). *Cf.* Bernard S. Sharfman, *Using the Law to Reduce Systemic Risk*, 36 J. CORP. L. 607, 609–10, 615 (2011), *available at* http://ssrn.com/abstract=1711927 (arguing that systemic risk should be reduced, but not eliminated, because it is a necessary byproduct of a successful economy).

25. *See generally* Dodd-Frank Act § 1412, 124 Stat. at 2145–48 (codified at 15 U.S.C. § 1639c(b)). The Dodd-Frank Act requires that the Bureau promulgate rules relating to Qualified Mortgages. *Id.*

26. *Id.* The "safe harbor" is a rebuttable presumption that a Qualified Mortgage meets section 1411 of the Dodd-Frank Act's "ability to repay" standards. *Id. See generally id.* § 1411(a)(2), 124 Stat. at 2142 (codified at 15 U.S.C. § 1639c(a)). Federal Housing Administration- (FHA) and other Government Sponsored Entity- (GSE) insured loans are exempt from the "skin in the game requirements." *See id.* § 941(b), 124 Stat. at 1891–96 (codified at 15 U.S.C. § 75o-11(c)(1)(G)(ii)) (requiring that several government agencies promulgate "a total or partial exemption" for FHA- and GSE-insured loans, thus excluding the loans from the "credit risk retention requirements").

The term "Qualified Residential Mortgage" delineates, on the other hand,

> which loans will be exempt from requirements that at least five percent of the credit risk be retained by the securitizer. While the [Qualified Mortgage] "ability to repay" obligation will apply to all residential mortgages, the [Qualified Residential Mortgage] definition will apply only to mortgages that are privately securitized.

Robert G. Quercia et al., Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages 2–3 (Mar. 5, 2012) (unpublished research report), *available at* http://www.ccc.unc.edu/documents/QRM%20Underwriting.3.2012.pdf.

vanilla" mortgage option that lenders will want to originate because it poses fewer regulatory and litigation risks.[27]

This plain vanilla option is meant to crowd out a number of abusive practices that sprang up during the subprime boom. Although not labeled explicitly, the elements of the Qualified Mortgage definition are tied to notorious mortgage products.[28] The first element bars negatively amortizing mortgages;[29] the second bars liar loans;[30] the third bars balloon payments, which protects borrowers from payment shock;[31] the fourth bars underwriting based on teaser and adjustable interest rates, again to limit payment shock;[32] the fifth bars equity-based lending;[33] the sixth limits high points and fees to limit equity stripping;[34] and the seventh limits mortgage terms to thirty years to reduce the likelihood of a borrower being caught in an endless cycle of debt.[35]

III. THE ROAD AHEAD

Can this new regulatory approach to shadow mortgage banking succeed? It does face a lot of challenges at both the origination level as well as the securitization level. It says that paternalism is appropriate in some

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27. John Pottow, *Ability to Pay*, 8 BERKELEY BUS. L.J. 175, 175–76 (2011). The definitions of Qualified Mortgage and Qualified Residential Mortgage bring back to life the "plain vanilla" mortgage option that had been heatedly debated before the Dodd-Frank Act was adopted but had been rejected in its original incarnation. *Id.*

28. Reiss, *Message in a Mortgage*, *supra* note 22, at 723.

29. *Id.*

30. *See* Joe Nocera, *In Prison for Taking a Liar Loan*, N.Y. TIMES, Mar. 26, 2011, at B1 (describing consumer convicted for fraud on applications for stated-income loans, the formal term for "liar loans").

31. "Balloon payments" are loans where "monthly payments are lower but one large payment (the balloon payment) is due when the loan matures. Predatory loans may contain a balloon payment that the borrower is unlikely to be able to afford . . . . Sometimes, lenders market a low monthly payment without adequate disclosure of the balloon payment." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 19 (2004) [hereinafter GAO, CONSUMER PROTECTION].

32. "[P]ayment shock is the percentage increase (or decrease) in the monthly payment relative to the payment in the previous year." Brent W. Ambrose et al., *A Note on Hybrid Mortgages*, 33 REAL EST. ECON. 765, 773 (2005).

33. "Equity-based lending" is a type of mortgage lending where "lenders make loans based on the amount of the homeowner's equity, even if it may appear that the borrower has insufficient income to make monthly payments," and often without regard for the borrower's ability to repay the loan. Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 337 (2005).

34. *See* GAO, CONSUMER PROTECTION, *supra* note 31 ("Mortgage originators may refinance borrowers' loans repeatedly in a short period of time without any economic gain for the borrower. With each successive refinancing, these originators charge high fees that 'strip' borrowers' equity in their homes.").

35. Dodd-Frank Act, Pub. L. No. 111-203, § 1412, 124 Stat. 1376, 2145–46 (2010) (codified at 15 U.S.C. § 1639c(b)(2)(A)(viii)). See Reiss, *Message in a Mortgage*, *supra* note 22, at 723–24, for a more detailed treatment. Qualified Mortgages also have a limitation on prepayment penalties. Dodd-Frank Act § 1414(a), 124 Stat. at 2149 (codified at 15 U.S.C. § 1639c(c)(4)). Qualified Mortgage prepayment penalties must be no greater than 3 percent and must phase out over a three-year period. *Id.* This provision also reduces the opportunities for equity stripping.

contexts, it limits the flexibility of parties to modify a mortgage as compared to how society regulates goods and services generally, it may restrict credit needlessly, and it may be irrelevant.

A. PATERNALISTIC

It had long been the view among economists that consumer protection is paternalistic to the extent that consumers are rational.[36] Behavioral economics has challenged this notion, demonstrating that consumers can behave in predictably irrational (and indeed, in some cases, in rationally ignorant) ways.[37] The Subprime Bust has made paternalism much easier to swallow as a policy choice because so many market participants have made such spectacularly bad choices. Additionally, behavioral economics has provided a theoretical justification for paternalistic government policies in the mortgage markets that some had found lacking until recently.

B. LIMITS FLEXIBILITY

It is well established that rules-based regulation is less flexible than a standards-based approach or an unfettered market, for that matter. The definition of a Qualified Mortgage surely falls within the scope of rules-based regulation, with its bars on numerous mortgage characteristics.[38] The Dodd-Frank Act did, however, build significant regulatory flexibility into its regulation of mortgages. Dodd-Frank authorizes regulators to "prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage."[39] It remains to be seen whether regulators will be nimble enough to deploy such flexibility, but the option is certainly there.

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36. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 15–17 (3d ed. 1986) (defending the assumption that people are rational). *See generally* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211 (2003) (discussing tension between paternalistic consumer regulation and self-determination). Public choice theorists might characterize consumer protection regulation in even worse terms: it is the product of rent-seekers who hope to gain favorable regulations to benefit themselves and who may couch the regulations in consumer protection garb in order to make it more palatable politically. *See generally* JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962) (setting forth a theory of public choice).

37. *See generally* Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980) (arguing that in certain situations, consumer behavior is contrary to economic theory).

38. Dodd-Frank Act § 1412, 124 Stat. at 2145–46 (codified at 15 U.S.C. § 1639c(b)) (defining "Qualifying Mortgage"); *see supra* text accompanying note 35.

39. Dodd-Frank Act § 1412, 124 Stat. at 2148 (codified at 15 U.S.C. § 1639c(b)(3)(B)); *see also* 15 U.S.C. § 78o-11(e) (allowing Federal banking agencies and the U.S. Securities and Exchange Commission to adopt exemptions, exceptions, and adjustments to "skin in the game" requirements).

C. RESTRICTS CREDIT

Consumer advocates and real estate industry trade groups argue that strict underwriting criteria contained in the proposed Qualified Residential Mortgage definition will restrict credit to many who could benefit from it because of its high down payment requirements.[40] Finding the right balance between responsible underwriting and access to credit is, of course, key. But again, Dodd-Frank has the flexibility to achieve that result.

D. POSSIBLY IRRELEVANT

The Qualified Mortgage and its statutory sibling, the Qualified Residential Mortgage, also face serious challenges in the secondary mortgage market. The Qualified Mortgage and Qualified Residential Mortgage definitions may be too narrow such that they will not crowd out less consumer-friendly mortgage products from the market.[41] Alternatively, the definitions could be too broad such that they allow many risky mortgage products.[42] Both paths could lead to a return to a mortgage market where abusive lending practices come back with a vengeance and pose systemic risk to the financial system. Finally, the definitions could be just so lousy that they could lead to a dormant mortgage market, with a concomitant catatonic housing market. Thus, a key question is whether the definitions achieve a sweet spot among the approaches that could be taken.[43]

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40. COAL. FOR SENSIBLE HOUS. POLICY, PROPOSED QUALIFIED RESIDENTIAL MORTGAGE DEFINITION HARMS CREDITWORTHY BORROWERS WHILE FRUSTRATING HOUSING RECOVERY 1 (2011), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/Coalition-QRM-White-Paper-1.pdf. The Coalition argues that

> once you apply the strong underwriting standards in the sample QRM definition, moving from a 5 percent to a 10 percent down payment requirement reduces the overall default experience by an average of only two- to three-tenths of one percent for each cohort year. However, the increase in the minimum down payment from 5 percent to 10 percent would eliminate from 4 to 7 percent of borrowers from qualifying for a lower rate QRM loan.

Id. at 6.

41. Levitin et al., *supra* note 7, at 164. Many argue that narrow Qualified Mortgage and Qualified Residential Mortgage definitions will be detrimental to the growth of the mortgage market. *See* Quercia et al., *supra* note 26, at 6, 10, 27–29, 33–35 (arguing that stringent underwriting requirements for Qualified Mortgages will provide a small increase in foreclosure reduction at the cost of significant restrictions in credit access for low- to middle-income borrowers); *see also* Raymond Natter, *Congressional Intent Regarding the Qualified Mortgage Provision*, 98 BANKING REP. (BNA) 921, 923 (May 22, 2012) (discussing congressional concern that a narrow definition will result in unanticipated restrictions in "mortgage credit availability for traditional loans," and that a narrow definition will prevent regulation from keeping up with financial products developed in the future).

42. Levitin et al., *supra* note 7, at 164. A related question is whether regulators can keep up with market participants as they attempt to circumvent the spirit of the regulations while complying with their letter. *See infra* note 66.

43. *See* Levitin et al., *supra* note 7, at 164.

IV. THE BUREAU'S AGENDA

The agenda of the Consumer Financial Protection Bureau (the Bureau) has begun to take shape. The Bureau is the new agency created by Dodd-Frank that has much of the authority over Dodd-Frank's mortgage-related provisions.[44] The Bureau's Assistant Director for Regulations, Leonard N. Chanin, stated that the "bulk of the [B]ureau's activities" in 2012 will be occupied by providing guidance regarding mortgage statutes and rulemaking.[45] The most important initiatives will be finalizing the rules for Dodd-Frank's "ability to repay" and Qualified Mortgages provisions.[46] Chanin also noted that "[p]retty much the entire mortgage arena as we know it will be covered by the rules . . . [and] a lot of future rule makings really hinge on the adoption of these rules because they are so broad in terms of the mortgage market."[47]

The Bureau's agenda for residential mortgage regulation can be inferred from its various proposed rulemakings, requests for comments, and consumer initiatives. The Bureau is clearly focusing on broadly accepted forms of consumer protection, such as disclosure requirements and consumer education, that address information asymmetries in the financial markets. It is also promulgating paternalistic regulations that set up bright-line rules for products and behavior in the mortgage market, and is complementing such regulations with closer supervision for formerly under-regulated mortgage market actors—the shadow mortgage banking sector.

This Part will provide a brief overview of the Bureau's activities thus far and its agenda for the immediate future with regard to home mortgage lending regulation.

A. DISCLOSURE

Disclosure requirements are designed to reduce information asymmetries between consumers and producers.[48] Disclosure requirements are accepted across the political spectrum.[49] Nonetheless, it is unclear how

44. Dodd-Frank Act § 1400(b), 124 Stat. at 2136 (codified at 12 U.S.C. § 5481) (naming the "Mortgage Reform and Anti-Predatory Lending Act" as an enumerated consumer law which falls under the purview of the Bureau).

45. Stephen Joyce, *Official: CFPB Will Exert Bulk of Rule-Writing Efforts in 2012 on Mortgage-Related Rules*, 98 BANKING REP. (BNA) 136, 136 (Jan. 24, 2012).

46. *Id.*

47. *Id.*

48. *See generally* Camerer et al., *supra* note 36, at 1232–33 (discussing the value of disclosure requirements under the Federal Truth in Lending Act in order to give uneducated consumers the opportunity to make more informed decisions).

49. *Id.* (noting the ubiquity and benefits of disclosure in a consumer protection context).

effective disclosure requirements are and whether the Bureau's efforts in this regard will be more successful than those that have come before.[50]

The Bureau is working to increase transparency and the exchange of information between borrowers and lenders through two initiatives. First, the Bureau is developing a consolidated mortgage loan disclosures proposal to consolidate mortgage loan disclosures and related rules under TILA and the Real Estate Settlement Procedures Act.[51] As a part of the Bureau's "Know Before You Owe" initiative, the Bureau will combine the TILA disclosure with the HUD-1 Settlement Statement that lenders give to consumers taking out loans to purchase a home or refinance a mortgage.[52] The Bureau is currently in the final rounds of testing and soliciting comments on their proposed Loan Estimate and Settlement Disclosure forms.[53]

The Bureau is also proposing new rules relating to the servicing of mortgages.[54] These proposals include requirements for clearer mortgage statements; clear warnings before the interest rates on adjustable rate mortgages (ARMs) adjust; options for avoiding lender-imposed "force-placed" property insurance; and lender options for avoiding foreclosure.[55] The proposals also include requirements that mortgage payments be immediately credited; payment records be kept as up-to-date and as

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50. *See generally* Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707 (2006) (arguing that mandatory disclosure may be insufficient to overcome consumer decision-making heuristics).

51. Dodd-Frank Act, Pub. L. No. 111-203, § 1032(f), 124 Stat. 1376, 2007 (2010) (codified at 12 U.S.C. § 5532 (2010)); *see also Fall 2011 Statement of Regulatory Priorities*, CFPB, http://www.consumerfinance.gov/regulations/fall-2011-statement-of-regulatory-priorities/ (last visited on Jan. 12, 2013) [hereinafter *Regulatory Priorities*].

52. Press Release, CFPB, Consumer Financial Protection Bureau Proposes "Know Before You Owe" Mortgage Forms (July 9, 2012), http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-proposes-know-before-you-owe-mortgage-forms/. The HUD-1 "is a document that lists all charges and credits to the buyer and to the seller in a real estate settlement."*What is a HUD-1*?, CFPB (Mar. 22, 2012), http://www.consumerfinance.gov/askcfpb/178/what-is-a-hud-1.html.

53. The CFPB Mortgage Disclosure Team, *Know Before You Owe: The Last Dance . . . or Is It?*, CFPB BLOG (Feb. 19, 2012), http://www.consumerfinance.gov/blog/. The Loan Estimate form is a disclosure form given to consumers detailing the loan terms, projected payments, closing cost details, comparisons with other loans, and other relevant considerations. *See* CFPB, LOAN ESTIMATE FORM (2012), http://files.consumerfinance.gov/f/2012/02/20120220_cfpb_tupelo-loan-estimate.pdf (providing sample Loan Estimate form). The Settlement Disclosure form is a statement of final loan terms and closing costs. CFPB, SETTLEMENT DISCLOSURE FORM (2012), http://files.consumerfinance.gov/f/2012/02/20120220_cfpb_basswood-settlement-disclosure.pdf (providing sample Settlement Disclosure form).

54. For a summary of the CFPB's proposals in this area, see CFPB, PUTTING THE 'SERVICE' BACK IN MORTGAGE SERVICING: NO SURPRISE, NO RUNAROUNDS, (2012), http://files.consumerfinance.gov/f/201204_cfpb_factsheet_putting-service-back-in-mortgage-servicing.pdf [hereinafter NO SURPRISE]. For a more detailed description of the CFPB's proposals, see CFPB, FINAL REPORT OF THE SMALL BUSINESS REVIEW PANEL ON CFPB'S PROPOSALS UNDER CONSIDERATION FOR MORTGAGE SERVICING RULEMAKING (2012), http://files.consumerfinance.gov/f/201208_cfpb_SBREFA_Report.pdf.

55. *See* NO SURPRISE, *supra* note 54, at 2–3.

accessible as possible given the size of the servicer; errors be corrected as quickly as possible; and foreclosure prevention teams be maintained by the servicer.[56]

Finally, the Bureau is issuing, pursuant to Dodd-Frank, a monthly mortgage statement form,[57] which is intended to assist consumers in appropriate budgeting.[58] The form will include information about key current loan terms (principal amount and interest rate) and key information about the mortgage, such as the reset date for ARMs and the amount of any late or prepayment fees.[59] Finally, it contains information about how to contact housing counselors if the homeowner is in financial distress.[60]

It is encouraging to note that the Bureau is testing its new disclosure forms. But the Bureau has not yet made clear whether it will be testing them once they are adopted. Only ongoing testing will determine whether improved disclosures will actually have a systemic impact on consumer choices.[61]

B. EDUCATION

Some, including Bureau leadership, believe that financial education for consumers is key to consumer protection because better educated consumers make better informed loan decisions.[62] Others are more skeptical.[63] The Bureau provides mortgage payment and foreclosure prevention advice on its website.[64] The Bureau's website also provides referrals to local foreclosure prevention resources and specialized assistance for servicemen and veterans.[65] As these measures are still in their infancy, the jury is still out as to whether these education efforts will improve outcomes for individuals and the financial system. As with the disclosure

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56. *See id.* at 3–4.

57. Dodd-Frank Act, Pub. L. No. 111-203, § 1420, 124 Stat. 1376, 2156 (2010) (codified at 15 U.S.C. § 1638 (2010)).

58. *See* Whitney Patross, *A Model Form for Mortgage Statements*, CFPB BLOG (Feb. 13, 2012), http://www.consumerfinance.gov/blog/. The CFPB has created a prototype Mortgage Statement form. CFPB, DRAFT PERIODIC MORTGAGE STATEMENT (2012), http://files.consumerfinance.gov/f/2012/02/20120213_cfpb_draft-periodic-mortgage-statement.pdf.

59. *See* Patross, *supra* note 58.

60. *See id.*

61. *See generally* Willis, *supra* note 50.

62. *See, e.g.*, CFPB, BUILDING THE CFPB: A PROGRESS REPORT 19 (2011), http://files.consumerfinance.gov/f/2011/07/Report_BuildingTheCfpb1.pdf ("This division provides, through a variety of initiatives and methods, information to consumers that will allow them to make the decisions that are best for them. Consumer education is a central mission of the Bureau.").

63. *See, e.g.*, Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 201 (2008) ("The gulf between the literacy levels of most Americans and that required to assess the plethora of credit, insurance, and investment products sold today—and new products as they are invented tomorrow—realistically will not be bridged.").

64. *Mortgage Help*, CFPB, http://www.consumerfinance.gov/mortgagehelp/ (last visited Aug. 30, 2012).

65. *Id.*

initiatives described above, ongoing empirical testing will be key to demonstrating the impact of the Bureau's consumer education initiatives.

C. BRIGHT-LINE RULES AND INCREASED SUPERVISION

Government-run consumer protection regimes premised on bright-line rules are vulnerable to evasion by nimble, profit-maximizing private sector actors.[66] Nonetheless, many of the worst excesses of the Subprime Boom arose from a small number of underwriting innovations, such as "equity based lending" and "liar loans."[67] Dodd-Frank, as implemented by the Bureau, bans some of the worst of these "innovations" and incentivizes the private sector to use some of the others much less frequently than they did during the Boom.[68] As with the disclosure and education initiatives, it remains to be seen how effective this approach will be.

One of the most important tasks for the Bureau in this regard is to finalize the hotly debated definitions for Qualified Mortgages and Qualified Residential Mortgages discussed above.[69] The Bureau's regulatory authority has extended from supervision of banking institutions to now include nonbanks as well.[70] The Bureau will assess whether nonbanks are in violation of federal consumer financial laws, including TILA and the Equal Credit Opportunity Act (ECOA).[71] This will be accomplished by employing "a risk-based nonbank supervision program" that focuses on "risks posed to consumers."[72] The Bureau has issued a proposal for public comment[73]

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66. *See* Eric Posner & Richard Hynes, *The Law and Economics of Consumer Finance*, 4 AM. LAW & ECON. REV. 168, 197–98 (2002) ("[I]t is not clear how much the law would influence the behavior of even a rational, well-informed consumer, given the many loopholes, the limited penalty structures, and the many ways in which creditors can evade the law and creditors and debtors can contract around it.").

67. ENGEL & MCCOY, *supra* note 9, at 35–38.

68. *See* Reiss, *Message in a Mortgage*, *supra* note 22, at 722–24 (explaining how the Dodd-Frank Act's "Qualified Mortgage" and "Qualified Residential Mortgage" options incentivize lenders to choose a "plain vanilla" type mortgage that exposes them to fewer regulatory and litigation risks by abstaining from certain abusive lending practices that were popular leading up to the Subprime Boom).

69. *See Regulatory Priorities*, *supra* note 51.

70. Peggy Twohig & Steve Antonakes, *The CFPB Launches its Nonbank Supervision Program*, CFPB BLOG, http://www.consumerfinance.gov/blog/the-cfpb-launches-its-nonbank-supervision-program/ ("[T]he CFPB has authority to oversee nonbank businesses, regardless of size, in certain markets: mortgage companies (originators, brokers, and servicers, and loan modification or foreclosure relief services); payday lenders; and private education lenders.").

71. *Id.*

72. *Id.*

> [N]onbank examination will be the same as [the CFPB's] approach to bank examination. It may include a combination of any of the following tools: requiring nonbanks to file certain reports, reviewing the materials the companies actually use to offer those products and services, reviewing their compliance systems and procedures, and reviewing what they promised consumers.

Id.

describing procedures that will allow it to "notify a nonbank firm that it is being considered for supervision because the [B]ureau 'may have reasonable cause' to determine that the financial products or services offered pose risks to consumers."[74] While these notifications do not constitute charges for an alleged consumer protection violation, they are a way for the Bureau to reach nonbanks and notify them that they are being individually supervised by the Bureau.[75]

The Bureau has also expanded its regulatory scope by issuing notices to the mortgage loan industry regarding regulation and advised practices. For example, Director Cordray has stated that the Bureau will apply the disparate impact doctrine, or "effects test," when enforcing the ECOA.[76]

Finally, the Bureau has acknowledged that flexibility is essential to a properly functioning market. This doctrine is reflected in the Bureau's efforts to address concerns particular to nonbank and smaller banking entities.[77] It has also manifested a sensitivity to concerns about over-regulation. This has been seen in its willingness to adapt to changing market realities, as evinced in the Bureau's final regulations regarding Home Mortgage Disclosure (Regulation C).[78]

As noted above, the Bureau has to walk a fine line between protecting consumers from poor choices on the one hand and limiting consumer choice on the other.[79] If it goes too far in one direction, it can reduce access to credit. If it goes too far in the other, it can leave consumers to fend for themselves against rapacious lenders in a predatory market. The stakes for

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73. Procedural Rules to Establish Supervisory Authority over Certain Nonbank Covered Persons Based on Risk Determination, 77 Fed. Reg. 31,226 (May 25, 2012) (to be codified at 12 C.F.R. pt. 1091).

74. Mike Ferullo, *Consumer Bureau Lays out Procedures for Notifying Nonbank Firms of Supervision*, 98 BANKING REP. (BNA) 941, 941 (May 29, 2012).

75. *See id.*

76. Richard Cordray, Dir., CFPB, Keynote Address at the National Community Reinvestment Coalition (Apr. 18, 2012), *available at* http://www.consumerfinance.gov/speeches/prepared-remarks-by-richard-cordray/; *see also* CFPB, CFPB BULL. 2012-04 (FAIR LENDING): LENDING DISCRIMINATION 1, 2 (2012) (discussing the applicability of disparate impact doctrine, also known as the "effects test," to enforce compliance with ECOA).

77. *Community Banks and Credit Unions*, CFPB (2012), http://www.consumerfinance.gov/small-financial-services-providers/. The Bureau has established an Office for Community Banks and Credit Unions "to ensure that the Bureau incorporates the perspectives of small depository institutions into our policy-making process; to communicate relevant policy initiatives to community banks and credit unions; and to work with community banks and credit unions to identify potential areas for regulatory simplification." *Id.*

78. *See* 12 C.F.R. pt. 1003 (2012). For example, Regulation C provides that the asset threshold for an entity to be considered a "financial institution" fluctuates annually. *Id.* § 1003.2 (defining the term "financial institution"). Based on the most recent threshold, mortgage lenders in metropolitan areas with assets of $41 million or less are exempt from the requirement to collect data about their housing-related lending activities in 2012. Home Mortgage Disclosure (Regulation C), 77 Fed. Reg. 8721, 9722 (Feb. 15, 2012) (to be codified at 12 C.F.R. pt. 1003, app. B).

79. *See supra* at Parts IV.A–C.

homeowners and the housing sector are as high as can be.[80] But the broader impact is also of great consequence, given the role that housing and residential construction play in the overall economy.[81]

CONCLUSION

While the initial signals are positive, the jury is still out on how effective the Dodd-Frank consumer protection regime, as implemented by the Bureau, will be in protecting homeowners and promoting a vibrant market for residential mortgages. A preliminary evaluation indicates that the Bureau is balancing increased regulation with regulatory flexibility, implicitly acknowledging that such flexibility is necessary for a properly functioning market. Such an approach bodes well for consumers. As such, it may also bode well for a reduction in systemic risk in this sector of the financial industry—the sector that gave us the Subprime Crisis. This is because that crisis demonstrated that a large sector of the consumer economy can go off the rails for quite some time before the financial markets take note.[82] To the extent that consumer protection regulation keeps a sector from doing so, it can reduce systemic risk.

The role of consumer protection should always be front and center in discussions of shadow mortgage banking regulation. It is essential to healthy markets for the origination and securitization of residential mortgages, and it is essential to the legitimacy and functioning of the financial system overall. And, as past experience has shown, we leave it in the shadows at our peril.

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80. *See generally* ENGEL & MCCOY, *supra* note 9, at 15–42 (discussing the "emergence of the subprime market").

81. *See generally id.* at 99–122 (discussing the financial "meltdown" that occurred from 2008–2009).

82. *See generally id.*