PRINCIPLES-BASED REGULATION AND LEGISLATIVE CONGRUENCE

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> "I have been asked many times as regard to particular practices or agreements as to whether they were legal or illegal . . . . One [group of] gentlemen said to me, 'We do not know where we can go.' To which I replied, 'I think your lawyers or anyone else can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone, you may slip and go over; but anybody can tell you where you can walk perfectly safe within convenient distance of that precipice.' The difficulty which men have felt . . . has been rather that they have wanted to go the limit rather than that they have wanted to go safely."[1]

Introduction

In 2007 and 2008 Professor Elizabeth Warren proposed a new federal consumer financial protection agency.[2] The aim was to ensure that financial products for consumers meet minimum safety standards.[3] That proposal became part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act).[4] This article explores whether the Act will usher in a new era of robust consumer protection in the mortgage markets. Its study of the mortgage markets occurs in an environment in which a principles-based approach to regulation was embraced in the 1982–2009 era. The Act altered that regulatory environment by re-imposing a rules-based regulatory regime on the mortgage markets. However, in her first major speech as special assistant to the President, Elizabeth Warren endorsed reliance on a principles-based approach to many of the future issues to be addressed by the new Consumer Financial Protection Bureau.[5] This reignites the debate over whether a rules-based or principles-based regulatory regime is more likely to lead to industry compliance and market outcomes that serve the legislative purposes embraced by Congress. This article utilizes an evidence-based approach to evaluate predicted pol-

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1. Harry First, Business Crime: Cases and Materials 27 (1990) (quoting *Hearings on S. Res. No 98 Before the Senate Comm. on Interstate Commerce*, 62d. Cong. 1611 (1911) (statement of Louis Brandeis)) (discussing the standard contained in the Sherman Act).

2. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. Pa. L. Rev. 1 (2008); Elizabeth Warren, *Unsafe at Any Rate*, Democracy, Summer 2007, at 7, 8.

3. Warren, *supra* note 2, at 17.

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 5, 7, 12, 15, 22, 26, 28, 31 and 42 U.S.C.).

5. Brady Dennis, *Warren Extends Olive Branch to Bankers*, Wash. Post, Sept. 29, 2010, http://voices.washingtonpost.com/political-economy/2010/09/warren_extends_olive_branch_to.html.

icy outcomes associated with principles-based and rules-based regulatory regimes.

The primary aim of any regulatory regime is to achieve legislative congruence,[6] namely to induce industry actions that are in compliance with statutory requirements but also serve legislative purposes. Principles-based regulation relies upon substantive standards or objectives imposed on industry members to achieve legislative purposes. It imposes a general standard for conduct—leaving it to the discretion of regulators to decide if particular conduct should trigger a sanction. On the other hand, rules-based regulation relies upon detailed, prescriptive requirements,[7] specifying in advance what specific actions will be penalized. It specifies the trigger for a sanction and, at times, the specific sanction to be imposed. Academic literature has explored various advantages and disadvantages of employing each regulatory regime.[8]

Principles-based regulation, arguably, is more likely to result in congruence with legislative purposes by avoiding "creative" compli-

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6. *See* Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 67 (1983) (discussing transparency, accessibility and congruence, with transparency and accessibility affecting the success of a regime in meeting the legislative purpose).

7. Julia Black et al., *Making a Success of Principles-Based Regulation*, 1 L. & FIN. MARKETS REV. 191, 191–92 (2007); *see also* Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258 (1974) ("The difference between a rule and a standard is a matter of degree—the degree of precision."); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557, 559 (1992) (explaining that an alternative definition focuses on whether the law is given content ex ante (rules) or ex post (principles or standards)); Frederick Schauer, *The Tyranny of Choice and the Rulification of Standards*, 14 J. CONTEMP. LEGAL ISSUES 803, 803–04 (contrasting rules, such as speed limits, with standards, such as reasonableness, in order to demonstrate that standards "leave the details to be worked out upon application . . ."); Cass R. Sunstein, *Problems With Rules*, 83 CAL. L. REV. 953, 966–67 (1995) (arguing that "principles are more flexible than rules"). The definition used for purposes of this article does not embrace the further possible distinction between the moral or political justification for a law (principles) and a legal provision that needs specification to resolve individual cases but is not itself a justification for an outcome (standard). *But cf.* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1688 (1976) (distinguishing between rules on the one hand and principles and standards on the other, without further differentiating the latter).

8. Kaplow, *supra* note 7, at 621 (exploring the costs of formulating, understanding, and applying rules versus standards); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 383–89 (1986) (discussing effectiveness of each regime to achieve deterrence, effective delegation of functions, and communication between actors); Sunstein, *supra* note 7, at 978 (discussing costs of each regime to the actors); *see also* Diver, *supra* note 6, at 67–68 (discussing transparency, accessibility, and congruence with an underlying policy objective, as well as the transaction costs of administering the regime).

ance, or evasion.[9] Industry members face unpredictable liability when regulations are in the form of general principles, causing senior management to err on the side of caution.[10] Not all commentators favor principles-based regulation as the approach most likely to lead to industry compliance and overall legislative congruence.[11] Rules, arguably, increase the subjective probabilities that the proscribed conduct is punishable,[12] in part because of the ease of applying and enforcing the rule. This may discourage costly efforts to avoid compliance.[13]

Prior to 2007, which marks the beginning of the recent crisis in the mortgage markets, principles-based regulation was explored and accepted in the academic literature and government public policy releases as a means of achieving legislative congruence. The viewpoint of U.S. regulators, that principles-based regulations are preferable, is explored in detail below.[14] Other markets embraced a similar viewpoint. In April 2007, before the crisis in the mortgage markets, the Financial Services Authority (FSA)[15] in the United Kingdom argued that reliance on principles-based regulation produces more efficient markets and enhances the FSA's ability to meet its consumer protection objective, as well as its other statutory objectives.[16] This viewpoint was formally embraced by the FSA in 2000 and previously

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9. Black et al., *supra* note 7, at 193; Kennedy, *supra* note 7, at 1696.

10. *See* Steven L. Schwarcz, *The 'Principles' Paradox,* 10 EUR. BUS. ORG. L. REV. 175, 179–80 (2009) (discussing the academic literature); *see also* Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 46, 56–57 (2000) (presenting the argument but then noting its shortcomings).

11. Diver, *supra* note 6, at 73 (arguing that increased precision may increase compliance and decrease evasion or concealment costs, but may increase variance between intended and actual outcomes, and principles may also result in under- or over-inclusiveness in application); *see also* Ehrlich & Posner, *supra* note 7, at 262 (contending that rules discourage socially undesirable activities and encourage socially desirable ones); Korobkin, *supra* note 10, at 56–57 (explaining that rules are more likely to be over- and under- inclusive but also more likely to have a dynamic effect on social norms by encouraging socially desirable behavior).

12. *See* Ehrlich & Posner, *supra* note 7, at 262.

13. *See* Diver, *supra* note 6, at 72–73.

14. *See infra* Part I.B.

15. The FSA regulates financial services markets, exchanges and firms in the United Kingdom and has rulemaking, investigatory and enforcement powers. *See* Financial Services Authority, *About Us*, http://www.fsa.gov.uk/Pages/About/Who/index.shtml (last visited Nov. 28, 2011).

16. THE FINANCIAL SERVICES AUTHORITY, PRINCIPLES-BASED REGULATION: FOCUSING ON OUTCOMES THAT MATTER 7 (2007) [hereinafter FOCUSING ON THE OUTCOMES THAT MATTER], *available at* www.fsa.gov.uk/pubs/other/principles.pdf.

played an important role in the Bank of England's supervisory approach.[17]

This article utilizes an evidence-based approach to evaluate the predicted policy outcomes for a principles-based regulatory regime by examining the U.S. mortgage market experience during the last decade. Part I explores the embrace of principles-based regulation in the United States in the period after 1982 and subsequent market outcomes in the U.S. mortgage market during the last decade. Regulators expected a principles-based regulatory regime to result in congruence with legislative purposes, which included safe and sound mortgage lending and fairness in mortgage products and practices. To the contrary, a principles-based approach multiplied the offerings of unsafe, unsound and unfair loans and disserved, in the long-term, the legislative goal of access to credit.

Part II explores the Act's re-embrace of a rules-based approach to market regulation, arguing that the key factor that will determine whether the Act achieves legislative congruence is not the return to a rules-based regulatory regime. Rather, the most important influence will be effective enforcement measures. Experience demonstrates that industry compliance is largely based upon cost-benefit evaluations. Both compliance with explicit statutory directives and with possible future regulatory rules and principles that may be imposed by the Consumer Protection Bureau largely depend on enforcement measures that alter industry cost-benefit evaluations. From 2002 to 2009, existing enforcement mechanisms and agency decisions led the industry to conclude that evasion was the reasonable business decision. To correct industry conduct, the Act's regulatory proscriptions and sanctions must be applied in a manner that alters industry cost-benefit evaluations. This viewpoint was largely ignored in the policy debates over mortgage market regulation.

17. *Id*. at 3; Kern Alexander, *Principles v. Rules in Financial Regulation: Re-assessing the Balance in the Credit Crisis*, 10 EUR. BUS. ORG. L. REV. 169, 169–70 (2009).

I.
Reliance on Principles-Based Regulation: 1982–2009

A. Congruence with Legislative Purposes

Regulatory regimes are evaluated by assessing their success in achieving congruence with legislative purposes.[18] Congress embraces the following three goals for mortgage market operations in the United States: safety and soundness, access to credit (including equal opportunity for low- and moderate- income borrowers), and preventing unfair products and practices (often referred to in legislative history as abusive products and practices).

The first goal, safety and soundness in mortgage market operations, seeks to protect insured depository institutions and their affiliates.[19] It is a goal repeatedly voiced in legislation governing operations of insured depository institutions,[20] including real estate lending operations.[21] The Congressional response to losses in real estate lending operations during the 1980s exemplifies the concern for safety and soundness. Banks faced substantial losses in their real estate lending operations after Congress lifted the former statutory limits on the terms of real estate loans.[22] In response, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) forced

18. Black et al., *supra* note 7, at 194 (arguing that related to congruence is the aim to reduce the scope for creative compliance). In addition to congruence, what is sought in regulatory approaches is simplicity and ease of application, and clarity or certainty as to what is necessary to comply. *See* Diver, note 6.

19. *See* Gulf Fed. Sav. & Loan Assoc. v. Fed. Home Loan Bank Bd., 651 F.2d 259, 264 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982) ("[T]he breadth of the unsafe or unsafe practice formula is restricted by its limitation to practices with a reasonably direct effect on an association's financial soundness.").

20. *See, e.g.*, 12 U.S.C. § 1831p-1 (2006) (outlining safety and soundness standards for insured depository institutions). It is also repeatedly voiced in legislation as the basis for regulatory sanctions against insured depository institutions. *See, e.g.*, 12 U.S.C. § 1818(b)–(c), (e), (i) (2006).

21. *See* 12 U.S.C. § 371(a) (2006) (addressing real estate ending by national banks); *see also* 12 U.S.C. § 1463(a)(1) (2006) (addressing safe and sound operations of savings associations); 12 U.S.C. § 1828(o) (2006) (addressing safety and soundness in real estate lending by all insured depository institutions).

22. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.) (lifting state limits on interest rates); Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.). The Garn-St. Germain Depository Institutions Act authorized state chartered housing creditors to offer alternative mortgage transactions; *see* § 322, 96 Stat. at 1499 (amending 12 U.S.C. § 1464(c)(1)(B)) (modifying real estate lending authority of thrifts); § 403(a), 96 Stat. at 1510 (amending 12 U.S.C. § 371) (modifying real estate lending authority of national banks); § 804, 96 Stat. at

federal regulators to, "adopt uniform regulations prescribing standards for real estate lending by insured depository institutions."[23] The House Report on the FDICIA emphasized that the goal Congress sought to reaffirm was safety and soundness in real estate lending operations, accomplished in harmony with the goal of access to credit.[24] This is a goal Congress embraces not only for insured depository institutions, but also for the operations conducted by their affiliates.[25]

Access to credit is also a goal embraced by Congress for mortgage market operations and it was one justification for lifting the rigid statutory limits on mortgage products offered by federally chartered commercial banks and thrifts, accomplished in the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St. Germain Act),[26] as well as for the authorization of alternative mortgage transactions for state chartered institutions.[27] The Alternative Mortgage Transactions Parity Act, part of the Garn-St. Germain Act, contains a statement of legislative purpose that emphasizes providing "an adequate supply of credit secured by residential property."[28] It is a goal voiced in other legislation concerning the mortgage markets, including legislation directed at the operations of government sponsored enterprises and secondary market operations.[29]

1546–47 (codified at 12 U.S.C. § 3803) (modifying real estate lending authority of banks, credit unions and other housing creditors).

23. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 304, 105 Stat. 2236 (1991) (codified at 12 U.S.C. § 1828(o)).

24. H. Rep. No. 102-330, at 136 (1991) ("In prescribing standards, the agencies shall consider the risks presented to the insurance funds, the safety and soundness of the institution, and the availability of credit.").

25. 12 U.S.C. § 1843(c)(8), (j)(2)(A) (2006); Assoc. of Bank Travel Bureaus, Inc. v. Bd. of Governors of the Fed. Reserve Sys., 568 F.2d 549, 551–52 (7th Cir. 1978) ("The board's two-tier test . . . has been adopted and endorsed by every circuit to consider the question."); BankAmerica Co. v. Bd. of Governors of the Fed. Reserve Sys., 491 F.2d 985, 988 (9th Cir. 1974) (holding that the board is permitted to consider the risks of a particular activity to the bank holding company in determining whether a proposed activity is a proper incident to banking and consider such adverse effects "unsound banking practices"); *see also* Unfair or Deceptive Acts or Practices: Advanced Notice of Proposed Rulemaking, 72 Fed. Reg. 43,570, 43,572–73 (Aug. 6, 2007) (embracing safety, soundness and "a competitive industry that meets America's financial services needs.").

26. Garn-St. Germain Depository Institutions Act, § 322, 96 Stat. at 1499 (amending 12 U.S.C. § 1464(c)(1)(B)) (describing real estate lending authority of thrift institutions); § 403(a), 96 Stat. at 1475 (amending 12 U.S.C. § 371) (describing real estate lending authority of national banks).

27. §§ 802–805, 96 Stat. at 1545–48 (codified as amended in scattered sections of 12 U.S.C.).

28. § 802, 96 Stat. at 1545–46 (codified at 12 U.S.C. § 3801).

29. *See, e.g.*, Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, § 1302(7) (1992) (codified at 12 U.S.C. § 4501(7)) (ac-

Providing access to credit is a goal Congress sought in harmony with the goal of safety and soundness. The Conference Report on the Garn-St. Germain Act, for example, noted that Congress wanted to provide flexibility to federally chartered thrifts in order to improve both the range of services provided to customers and the ability to generate earnings and sustain capital needed for future operations.[30]

The Congressional goal of providing access to credit expanded to ensuring equal opportunity for low- and moderate- income borrowers and communities. This was, for example, the primary aim of the Community Reinvestment Act of 1977.[31] However, once again, Congress sought to harmonize the goal of access to credit with the goal of safety and soundness, stipulating that financial institutions should meet the credit needs of their local communities, including low- and moderate-income neighborhoods, "consistent with the safe and sound operation of such institution[s]."[32]

A third goal embraced by Congress is preventing unfair products and practices in credit markets, including mortgage products and practices. This goal applies to all entities that regularly extend credit to consumers, not just to insured depository institutions, and is evidenced in the Home Ownership and Equity Protection Act of 1994,[33] the Home Equity Loan Consumer Protection Act of 1988,[34] and the Real Estate Settlement Procedures Act of 1974.[35]

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knowledging that facilitating affordable housing and allowing institutions to maintain a strong financial condition are dual goals of Congress).

30. S. Rep. No. 97-641, at 87–88 (1982) (Conf. Rep.); *see also* S. Rep. No. 97-536, at 14 (1982) (noting that Congress was attempting to save the thrift industry by providing "asset-side empowerments capable of generating the earnings needed to support competitive rates").

31. 12 U.S.C. § 2901 (2006); *see also* Federal Housing Enterprises Financial Safety and Soundness Act § 1302(7) (affirming an obligation to promote affordable housing for low- and moderate- income families).

32. 12 U.S.C. § 2903(a)(1) (2006).

33. S. Rep. No. 103-169, at 2, 21–22, 24 (1993).

34. Act to Amend the Truth in Lending Act, Pub. L. No. 100-709, §§ 2, 3, 102 Stat. 4725, 4725–33 (1988) (amending scattered sections of 15 U.S.C.).

35. Real Estate Settlement Procedures Act of 1974, Pub. L. No. 93-533, § 2, 88 Stat. 1724 (1974) (codified at 12 U.S.C. § 2601) (articulating a need to address the real estate settlement process in order to protect and inform consumers); *see also* S. Rep. No. 93-866, at 2, 6 (1974) (discussing the problem of abusive and unreasonable practices within the real estate settlement process that increase settlement costs to home buyers without providing any real benefit to them). Indeed the Real Estate Settlement Procedures Act required the Secretary of Housing and Urban Development to monitor the implementation of the various anti-abusive and disclosure provisions of the bill and report back to Congress on whether there is any necessity for further legislation and the corrective measures that need to be taken. § 10, 88 Stat. 1728–29 (codified at 12 U.S.C. § 2609); S. Rep. No. 93-866, *reprinted in* 1974 U.S.C.C.A.N. 6553–54.

The Act affirms this third legislative goal while seeking, once again, to harmonize it with the goal of access to credit. Congress noted that economic stabilization would be enhanced by, "ensuring that responsible, affordable mortgage credit remains available to consumers . . . ."[36] Congress also sought to assure consumers receive residential mortgage loans on terms that are, "not unfair, deceptive or abusive."[37]

Given the three goals embraced by Congress for mortgage market operations, the challenge was to formulate a regulatory approach that best met these goals. Regulators from 1982 to 2009 primarily embraced a principles-based approach, in which they relied upon general standards of proper conduct and formulations of prohibited conduct to ensure congruence with legislative purposes.

B. U.S. Regulators Embrace Principles-Based Regulation

In 1982, with the adoption of the Garn-St. Germain Act, Congress lifted the rigid statutory constraints on mortgage lending by banks and thrifts.[38] As a result, federal banking agencies began to rely primarily on general principles to constrain industry actions in mortgage lending operations. No detailed limitations on national banks' real estate lending were imposed and the Office of the Comptroller of the Currency (OCC) rescinded earlier regulations that imposed such limitations. As a result bank lending practices were constrained solely based on the legislative standard of safety and soundness.[39] The OCC relied upon bank management to determine which practices were unsafe in order to facilitate banks' ability to respond to market conditions.[40] Similarly, after initially proposing to retain some regulatory requirements such as loan-to-value ratios, the Federal Home Loan Board removed most regulatory requirements for real estate loans in 1983;[41] by 1996, all the requirements were lifted.[42]

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36. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1402(a)(2), 124 Stat. 1376, 2139 (2010) (amending scattered sections of 15 U.S.C.).

37. *Id.*

38. Garn-St. Germain Depository Institutions Act of 1982, Pub. L. 97-320, § 322, 96 Stat. 1499 (1982) (amending 12 U.S.C. § 1464(c)(1)(B)); § 403(a), 96 Stat. 1510 (amending 12 U.S.C. § 371).

39. *See* 12 U.S.C. § 183 (2006); 12 U.S.C. § 1818(b)–(c), (e), (i) (2006); 12 U.S.C. §§ 371(a), 1463(a)(1), 1828(o) (2006).

40. Real Estate Lending by National Banks, 48 Fed. Reg. 40,698, 40,699–700 (Sept. 9, 1983).

41. Implementation of New Powers; Limitation on Loans to One Borrower, 48 Fed. Reg. 23,032, 23,035–37 (May 23, 1983). For home loans in excess of 90% of appraised value, private mortgage insurance was required for the part of the loan balance that exceeds 80% of the property's value. In addition, a loan could not exceed 100%

In the wake of the savings and loan crisis, the FDICIA forced the federal banking regulators to "adopt uniform regulations prescribing standards for extensions of credit . . . that are secured by liens on interests in real estate . . . ."[43] This could have led to a re-embrace of rules-based regulations, but it failed to do so. In response to the statute, the regulators made two decisions. The first decision was to issue guidelines for real estate lending, rather than impose regulations setting minimum and mandatory requirements. This is an approach the federal banking regulators generally continued to follow, until the Federal Reserve's imposition of mandatory rules governing underwriting of subprime loans, which became effective in October 2009.[44] After Congress mandated standards for real estate lending in the FDICIA, the real estate guidelines became the standard required by the statute. However, unlike regulation, guidelines are not mandatory; insured institutions need only consider the guidelines in establishing their own real estate lending policies.[45] Bank management could determine product terms and underwriting standards subject only to post facto intervention in the event of financial losses or the risk of financial losses by individual institutions. However, this post facto intervention—enforcement—did not occur.[46]

The second decision made by the regulators after the FDICIA was to employ a principles-based approach in their guidelines. After initially proposing specific loan-to-value ratio limits, the federal banking agencies decided to generally rely on a statement of principles to guide bank management in authorizing specific residential mortgage products and practices. Specifically, the agencies required that banks and thrifts establish and maintain written, internal real estate lending policies consistent with "safe and sound" banking practices and "prudent" underwriting standards.[47] For example, the Office of Thrift Su-

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of the appraised value of the real estate and a home loan could not have a maximum term longer than forty years. However, the loan-to-value requirement was permitted to jump to 125% of initial appraised value in the event of a loan that was not fully amortized or was an adjustable rate loan. *Id*. at 23,038.

42. Lending and Investment, 61 Fed. Reg. 50,951, 50,978–80 (Sept. 30, 1996).

43. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 304, 105 Stat. 2236, 2354 (1991) (codified at 12 U.S.C. § 1828(o)(1)).

44. Truth in Lending, 73 Fed. Reg. 44,522, 44,543 (July 30, 2008).

45. Office of Thrift Supervision, 61 Fed. Reg. 1162, 1163–64 (Jan. 17, 1996); Real Estate Lending Standards, 57 Fed. Reg. 62,890, 62,982–83 (Dec. 31, 1992).

46. *See infra* Part II.C.

47. Real Estate Lending Standards, 57 Fed. Reg. 62,890, 62,893 (Dec. 31, 1992). The guidelines did contain loan–to–value ratios for different types of real estate loans. However, the guidelines specified no loan-to-value limits for mortgages on owner-occupied one-to-four family residential property and for home equity loans. *Id.* Other requirements such as maximum maturity limits, amortization requirements and docu-

pervision's (OTS) regulations on real estate lending require that each savings association adopt and maintain written policies establishing appropriate limits and standards for extensions of credit secured by real estate, and that the policies be consistent with "safe and sound" banking practices and establish "prudent" underwriting standards.[48]

In addition to issuing cautionary guidelines expressing general principles, the regulators decided not to apply them to affiliates of banks and thrifts.[49] They reasoned that federal deposit insurance funds would not be at risk and secondary market investors already established underwriting requirements for such entities,[50] a market-based approach to ensuring safe operations are not constrained by mandatory, administrative rules. As a final example of a desire to limit the reach of even the general guidelines issued, the agencies excluded any loans that are to be "sold promptly after origination, within [sic] recourse, to a financially responsible third party."[51]

Both the nature of the standards—a principles-based approach and one contained in guidelines rather than regulations—and the exclusions contained in the guidelines reflect a regulatory desire to rely upon a free market approach to the fullest extent permitted by statute. The regulators embraced the view that principles would be sufficient to induce industry actors to ensure access to credit on terms that were not unsafe or unfair.

Abusive lending practices directed at consumers surfaced by the 1990s. In response, Congress enacted the Home Ownership and Equity Protection Act of 1994 (HOEPA).[52] HOEPA charged the Federal Reserve with formulating the regulatory regime. The terms of HOEPA specifically granted the Federal Reserve the power to prohibit or regulate unfair mortgage loans,[53] a power it did not exercise until recently.[54] Federal banking agencies have long been charged with the

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mentation requirements were rejected. *See* Real Estate Lending Standards: Supplementary Analysis, 57 Fed. Reg. 36,911, 36,911–12 (Aug. 17, 1992).

48. Lending and Investment, 61 Fed. Reg. 50,951, 50,978 (Sept. 30, 1996) (codified at 12 C.F.R. § 560.100-01).

49. Real Estate Lending Standards, 57 Fed. Reg. at 62,894.

50. *Id.*

51. *Id.* at 62,898.

52. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, §§ 151–58, 108 Stat. 2160, 2190–98 (1994) (amending scattered sections of 15 U.S.C.).

53. 15 U.S.C. § 1639(l)(2) (2006).

54. *See* Michael Hirsh, *Greenspan's Folly*, NEWSWEEK, Sept. 16, 2008, http://www.thedailybeast.com/newsweek/2008/09/16/greenspan-s-folly.html (criticizing the Federal Reserve for not exercising regulatory power under HOEPA before the subprime mortgage crisis).

duty to ensure that bank lending practices are conducted in a safe and sound manner and are in compliance with applicable consumer protection laws, including prohibitions against unfair and deceptive practices and fair lending requirements.[55] The Federal Trade Commission Act's (FTC Act) prohibition of unfair and deceptive practices became a second principles-based standard that applied to both depository institutions and mortgage companies.[56]

After abusive lending practices surfaced in 1996, the OTS, the successor to the Federal Home Loan Bank Board, embraced the same principles-based approach previously embraced by the OCC.[57] The new regulations contained no specific requirements governing real estate lending. Instead, the regulations required each association to establish and maintain policies "consistent with safe and sound banking practices" and "prudent underwriting standards."[58] In addition, it converted its earlier regulations into "handbook guidance."[59] This was done to allow the exercise of judgment by the industry and bank examiners.[60] In other words, bank management would set their own policies for real estate lending, guided by the OTS handbook and subject to post facto intervention to address financial losses. The accompanying guidance contained supervisory loan-to-value ratio limits for most real estate loans but none for loans secured by one to four family owner-occupied loans.[61]

Abusive practices surfaced after the 1996 revisions to the real estate lending standards, just as they surfaced prior to Congressional

55. *See* 15 U.S.C. § 57a(f) (2006) (requiring the Federal Reserve, Federal Home Loan Bank Board, and National Credit Union Administration Board to prescribe regulations, and also mandating that the appropriate federal bank regulators ensure compliance with statutory prohibitions against unfair and deceptive practices).

56. 15 U.S.C. § 45 (2006).

57. Office of Thrift Supervision, 61 Fed. Reg. 50,951 (Sept. 30, 1996) (stating that "OTS's objective in removing detail from some regulations and relying on a more general set of regulations and safety and soundness standards is to allow institutions greater flexibility in their lending operations" and "brings OTS's regulations into greater uniformity" with those of the other federal regulators).

58. *Id.* at 50,978–79.

59. For the proposed rulemaking, see Office of Thrift Supervision, 61 Fed. Reg. 1162, 1163 (Jan. 17, 1996). For the final rule, see Office of Thrift Supervision, 61 Fed. Reg. 50,951 (Sept. 30, 1996).

60. 61 Fed. Reg. at 1163–64. The reliance on bank management in setting polices for real estate lending and other activities was made clear when the OTS explained that its guidance should not be considered on the same level as regulatory law and was no supplement for management discretion. *Id.* at 1164.

61. Office of Thrift Supervision, Lending and Investment, 61 Fed. Reg. at 50,979.

intervention in both 1988 and in 1994.[62] The regulators responded to these abusive practices by issuing additional guidance. Between 1999 and 2001 the federal banking regulatory agencies issued three interagency guidance documents on real estate lending. The first guidance addressed subprime lending and was motivated by insured depository institutions increasingly originating subprime loans to increase profits, which exhibited significantly higher risks of default than traditional bank lending.[63] The second guidance addressed high loan-to-value residential real estate lending.[64] It was motivated by insured depository institutions increasingly originating residential real estate loans in amounts exceeding 80% of appraised value, to increase profits, and the far greater risks of default and severity of the losses associated with such loans.[65] The third guidance document, issued in 2001, also addressed subprime lending.[66] It too was motivated by the higher risks inherent in subprime lending programs and, for the first time, by recognition that some forms of subprime lending may be characterized as abusive or predatory.[67] All three guidance documents continued to rely primarily upon bank management to set policies for controlling the risks inherent in subprime and high loan-to-value lending programs, and to avoid possible violations of consumer protection laws.[68]

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62. S. Rep. No. 103-69, at 21–23 (1993) (discussing problematic lending practices in home equity lending that led to the Home Ownership and Equity Protection Act of 1994).

63. Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Office of Thrift Supervision, Interagency Guidance on Subprime Lending 1–2 (Mar. 1, 1999) [hereinafter Interagency Guidance on Subprime Lending], *available at* http://www.federalreserve.gov/boarddocs/srletters/1999/sr9906a1.pdf.

64. Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Office of Thrift Supervision, Interagency Guidance on High LTV Residential Real Estate Lending (Oct. 8, 1999) [hereinafter High LTV Real Estate Lending], *available at* http://www.federalreserve.gov/boarddocs/srletters/1999/sr9926a2.pdf.

65. *Id.* at 1–2.

66. Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp. & Office of Thrift Supervision, Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001) [hereinafter Expanded Guidance], *available at* http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf.

67. *Id.* at 10–11.

68. *Id*. at 3 (stating that examiners should assess the “risk management and control process” institutions have in place); High LTV Real Estate Lending, *supra* note 64, at 3 (stating that institutions engage in high LTV lending should have risk management procedures in place); Interagency Guidance on Subprime Lending *supra* note 63, at 2, 5–6 (requiring institutions engaging in subprime lending to ensure that policies and procedures address any additional risk, and any possible violation of consumer protection laws).

The 2001 guidance is the only instance of a regulatory initiative adding precision to the very general principles relied upon to govern mortgage lending operations. In the 2001 guidance, regulators recognized the existence of abusive lending practices, meaning practices that are of concern because they unfairly burden consumers. However, regulators did not prohibit the abusive practices. The 2001 guidance recognized that "some forms of subprime lending may be abusive or predatory. Some such lending practices appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value."[69] The guidance document identified the following characteristics of lending transactions as typically abusive or predatory:

> [M]aking unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation; inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.[70]

The 2001 guidance document did not impose constraints to address loan flipping or the deception of consumers that occurs when lenders conceal the true nature of the loan. To address loans made without regard to the borrower's ability to repay, the guidance added a greater degree of precision to the regulatory scheme of oversight via the examination process:

> [Loans] to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized . . . as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to their Agency's respective consumer compliance/fair lending specialists for additional review.[71]

The guidance again relied upon post facto regulatory intervention and intervention that was not assured, since "additional review" was all that was required.

In 2003 and 2004, there was a small shift in the OCC's regulatory approach, although reliance upon principles-based regulation re-

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69. Expanded Guidance, *supra* note 66, at 10.

70. *Id.* at 10–11.

71. *Id.* This guidance applies to institutions that have subprime lending programs with an aggregate credit exposure greater than or equal to twenty-five percent of tier one capital. *Id.* at 2.

mained the dominant viewpoint. In 2003, the OCC advised national banks to avoid originating loans without regard to the borrower's ability to repay, and extended the warning to avoid purchasing such loans originated by others.[72] The guidelines contained that advice and, at that time, the OCC relied upon bank management to formulate and implement appropriate policies to ensure that the borrower had the capacity to make scheduled payments,[73] and that loans purchased complied with the bank's general lending policies.[74]

In January 2004, the OCC did issue regulations prohibiting loans made without regard to ability to repay.[75] It is the only regulatory prohibition issued by a federal agency in real estate lending standards, and it applied only to the national bank and not to its affiliates. The regulation simultaneously preempted state predatory lending laws.[76] The net effect was to impose far fewer specific prohibitions (rules) on the full range of possible abusive lending practices by national banks.

All of the agencies' guidance documents on real estate lending applied only to the banks or thrifts themselves and their operating subsidiaries. They did not apply to mortgage affiliates of these institutions.[77] Failure to extend the regulatory guidance to bank and thrift affiliates was not explainable by a lack of supervisory power over mortgage affiliates. In 2006, the agencies issued new guidelines on real estate lending and for the first time imposed those guidelines on

72. Office of the Comptroller of the Currency, OCC Advisory Letter 2003-2, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices 7–8 (2003) [hereinafter OCC Advisory Letter 2003-2]; Office of the Comptroller of the Currency, OCC Advisory Letter 2003-3, Avoiding Predatory and Abusive Lending Practices in Borrowed and Purchased Loans 6–10 (2003) [hereinafter OCC Advisory Letter 2003-3].

73. OCC Advisory Letter 2003-2, *supra* note 72, at 7.

74. OCC Advisory Letter 2003-3, *supra* note 72, at 6.

75. Banking Activities and Operations, Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1904 (Jan. 13, 2004). The prohibition applies to national banks and their operating subsidiaries. *Id.*

76. *Id.* at 1904–05. Community and consumer advocates expressed concern that preemption would expose consumers to widespread predatory and abusive practices by national banks. *Id.* at 1906. The OCC, however, was concerned about the costs and burdens state predatory lending laws impose on national banks. *Id.* at 1907–08. It concluded that enforcement actions under federal law, such as the FTC Act, can ensure fair treatment of consumers. *Id.* at 1913–14. However, the FTC Act relied on principles-based regulation. *See* 15 U.S.C. § 57a(f) (2006). Studies documented the results of preemption of state law and concluded that risky lending by national banks more than doubled in some loan categories after preemption than before, jumping from 11% to 29%. S. Rep. No. 111-176, at 16 (2010) (citing studies by the Center for Community Capital, University of North Carolina).

77. *See, e.g.*, OCC Advisory Letter 2003-3, *supra* note 72, at 1 (framing the intended audience as national banks and their operating subsidiaries).

bank and thrift affiliates.[78] The Federal Reserve has long been granted supervisory authority over bank affiliates, including the power to determine which activities are "so closely related to banking as to be a proper incident thereto,"[79] and which activities produce possible adverse effects such as "unsound banking practices."[80] The OTS has similar authority over thrift affiliates.[81] The long delay in regulating the activities of mortgage affiliates further demonstrates the agencies' preference for minimal intervention in the mortgage markets and reliance instead on principles-based regulation, i.e. the directive to avoid unsound banking practices.

The agencies' last revisions of their uniform real estate lending standards came in 2006 and 2007. These standards can be described as too little, too late.[82] An interagency guidance issued in October 2006 addressed nontraditional mortgage products.[83] Specifically, the October 2006 guidance was motivated by both an increase in the mortgage industry of the use of interest-only and payment-option adjustable rate loans that allowed borrowers to defer payment of principal and, at times, interest; as well as the fact that many of these new non-traditional loans were being underwritten with "less stringent or no income and asset verification requirements."[84] The guidance continued to rely upon bank management to decide the policies and products that serve to minimize risks to the banks and thrifts.[85] It made only two changes. First, it cautioned banks to include an evaluation of the borrower's ability to repay the debt at final maturity at the fully indexed rate and

78. *See* Statement of Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,570 (July 10, 2007); Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,251 (Dec. 29, 2005).

79. 12 U.S.C. § 1843(c)(8) (2006); *see also* Assoc. of Bank Travel Bureaus, Inc. v. Bd. of Governors of the Fed. Reserve Sys., 568 F.2d 549, 551–52 (7th Cir. 1978) ("If the Board finds that the activity is closely related to banking within the meaning of the Act, it then must decide whether the activity is a 'proper incident' to banking . . ."); BankAmerica Corp. v. Bd. of Governors of the Fed. Reserve Sys., 491 F.2d 985, 988 (9th Cir. 1974) (noting that the board is required to consider the effects of "unsound banking practices" in determining whether an activity is a proper incident to banking).

80. 12 U.S.C. § 1843(j)(2)(A) (2006).

81. *See* Unfair or Deceptive Acts or Practices, 72 Fed. Reg. 43,570, 43,572–73 (Aug. 6, 2007).

82. Edmund L. Andrews, *Fed and Regulators Shrugged as the Subprime Crisis Spread*, N.Y. Times, Dec. 18, 2007, at A32.

83. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

84. Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,251–52 (proposed Dec. 29, 2005).

85. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,613.

assuming a fully amortizing repayment schedule,[86] and to demonstrate mitigating factors supporting the underwriting decision in the event of risk layering such as reduced documentation loans.[87] Second, for the first time, the agencies applied the guidance to bank and thrift affiliates.[88] While the agencies recognized the consumer protection issues raised by many product offerings, they continued to rely primarily upon disclosure to address such concerns.[89]

The interagency guidance issued in July 2007 was the last to address real estate lending. Concern over increasing use of adjustable rate mortgage products with low initial payments based on an introductory rate that expires after a short period motivated the guidance.[90] The guidance again states that prudent underwriting standards should include analysis of a borrower's repayment capacity at the loan's final maturity at the fully indexed rate assuming a fully amortizing repayment schedule.[91] It does not prohibit stated income and reduced documentation loans, but advised that such loans should be made to subprime borrowers only if there are mitigating factors such as substantial liquid reserves or assets.[92] Apart from cautioning that loan underwriting should consider the borrower's ability to repay, the guidance continued to rely on disclosure, rather than regulation, in order to protect consumers.[93]

86. *See id.* at 58,614.

87. *See id.*

88. Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. at 77,251.

89. "More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. . . . [C]ommunication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution." Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,616–17; *see also id.* at 58,612; Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. at 77,255 (stating that institutions should ensure consumers have information that is timely and sufficient for making a sound product decision).

90. ARMs, "typically offered to subprime borrowers, present heightened risk to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period." Statement on Subprime Lending, 72 Fed. Reg. 37,569, 37,569 (July 10, 2007).

91. *Id*. at 37,573 n.13.

92. *See id.*

93. *Id.* at 37,574. "Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include: [a]pproving loans based on the borrower's ability to repay the loan according to its terms; and [p]roviding informa-

A shift away from reliance on principles-based regulation occurred in July 2008, after the start of the current mortgage crisis, when the Federal Reserve issued regulations prohibiting certain mortgage loans to be underwritten without regard to ability to repay.[94] Such regulations did not become effective until October 2009.

After the lifting of statutory requirements for mortgage loans in 1982, mortgage lenders were subject to two principles-based restraints on their activities. Depository institutions were required to ensure their products and practices were "safe and sound" and their underwriting standards reflected "prudent" underwriting.[95] All mortgage lenders were required to avoid "unfair" products and practices.[96] The federal banking regulators relied upon bank management to ensure compliance with general principles contained in statutory and regulatory requirements. This was the case in the period between 1982 and October 2006. The only exception for banking institutions was the 2001 regulatory guidance that cautioned institutions against making loans based only on the value of the collateral and not on the borrower's ability to repay the loan. This provided some specificity to the general standards of safety and soundness, as well as avoiding unfair products and practices. However, compliance was not mandatory and the guidance only applied to institutions with subprime loan exposure equal to or greater than 25% of their capital. The only true shift to rules-based regulation occurred with the OCC's 2004 decision, affecting only national banks, to issue a regulation prohibiting loans made without regard to the ability to repay.

In the period prior to October 2009, non-bank mortgage lenders were similarly subject to principles-based regulations. Non-affiliated mortgage companies were subject to the FTC Act's principles-based regulation that prohibited "unfair" products and practices.[97] Mortgage companies affiliated with insured depository institutions faced the same FTC Act's principles-based regulation until October 2006, for

tion that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product." *Id.*

94. Truth in Lending, 73 Fed. Reg. 44,522, 44,539 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (the prohibition applies to "higher-priced mortgage loans" and HOEPA loans).

95. Real Estate Lending Standards, 57 Fed. Reg. 62,890, 62,893 (Dec. 31, 1992) (codified at 12 C.F.R. pts. 34, 208, 365, 545, 563); Implementation of New Powers; Limitation on Loans to One Borrower, 48 Fed. Reg. 23,032, 23,035–38 (May 23, 1983) (codified at 12 C.F.R. pts. 523, 526, 541, 545, 555, 561, 563).

96. 15 U.S.C. § 45(a)(2) (persons, partnerships and corporations other than banks, savings and loan associations or credit unions); § 57a(f)(1) (2006) (banks, savings and loan associations and credit unions).

97. *See id.*

nontraditional mortgages only, and until July 2007 for all other subprime mortgages.[98] Only then did the federal regulators extend to bank affiliates the non-mandatory, interagency guidance warning lenders to include consideration of a borrower's repayment capacity in their underwriting standards.[99] Bank-affiliated mortgage companies and non-affiliated mortgage companies are not regularly examined.[100] The market outcomes of this principles-based regime are explored in the next part.

C. Market Outcomes in a Principles-Based Regulatory Regime

The principles-based regulatory regime governing mortgage lending resulted in short-term profits for financial institutions, bolstering the soundness of those institutions.[101] However, the innovative mortgage products that generated a great deal of those profits eventually resulted in substantial losses for financial institutions that threatened the soundness of the U.S. banking system.[102] Access to credit and rates of homeownership increased, but this too was a short-term benefit. The risky features of these products ultimately eliminated all gains in rates of homeownership over the last decade.[103] They resulted in substantial economic losses for homeowners[104] and brought to light the abusive nature of innovative mortgage loans for consumers. The last decade also witnessed increased offerings of addi-

98. Statement on Subprime Lending, 72 Fed. Reg. 37,569, 37,573 (July 10, 2007); Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,251, 77,255 (Dec. 29, 2005).

99. Statement on Subprime Lending, 72 Fed Reg. at 37,573; Interagency Guidance on Nontraditional Mortgage Products, 70 Fed Reg. at 77,251, 77,255.

100. H.R. Rep. No. 111-517 at § 1024 (2010) (Conf. Rep.).

101. *See* S. Rep. No. 111-176, at 15 (2010) (Conf. Rep.) ("'[R]egulators routinely sacrificed consumer protection for short-term profitability of banks'. . . .").

102. *See Examining the State of the Banking Industry: Hearing Before the Subcomm. on Fin. Insts. of the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 56 (2009) [hereinafter Statement of Sheila C. Bair] (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Co.) (calling the financial recession caused by the mortgage crisis "historic" and noting the failure of several FDIC-insured institutions); *Quarterly Banking Profile: Fourth Quarter 2009*, 4 FDIC Q. 1, 16 (2010) (noting the large number of failures among FDIC-insured institutions); Fin. Crisis Inquiry Comm'n, The Financial Crisis Inquiry Report 401 (2011) [hereinafter Inquiry Report], *available at* http://www.fcic.gov/report.

103. Truth in Lending, 73 Fed. Reg. 44,522, 44,524 (July 30, 2008); Ctr. for Responsible Lending, Subprime Lending: A Net Drain on Homeownership 2 (2007) [hereinafter Net Drain].

104. Inquiry Report, *supra* note 102, at 402–03; Joint Ctr. for Hous. Studies of Harvard Univ., The State of the Nation's Housing: 2008 20 (2008) [hereinafter Joint Ctr. 2008], *available at* http://www.jchs.harvard.edu/publications/markets/son2008/son2008.pdf.

tional, unfair mortgage loans that continually stripped equity from consumers by charging them excessive rates and fees, meaning those not justified by underwriting costs or credit risk.[105] The goal of equal opportunity in the credit markets did not materialize. The unsafe and unfair products were more prevalent in lower-income communities, with the result that such communities were most severely impacted by losses due to foreclosures and ongoing equity stripping due to unfair terms in mortgage loans.[106] These results are documented below.

1. *Unsafe and Unsound Loans*

The mortgage products and practices that emerged in a principles-based regulatory regime included: adjustable rate mortgages (ARMs) with low initial rates that led to substantial increases in loan payments after expiration of the initial "teaser" rate; payment option loans, which grant borrowers the option to chose a minimum payment that did not include all accrued interest and did not amortize the principal, until a recast of the payments at a later point which significantly increased monthly payments; loans underwritten without regard to

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105. *See infra* Part I.C.3.

106. *See* Truth in Lending, 73 Fed. Reg. at 44,553–54 (finding that subprime loans were often targeted to less sophisticated borrowers with fewest financial resources); *see also* SHARON HERMANSON, AARP PUB. POLICY INST., FYI: THE SUBPRIME MARKET: WEALTH BUILDING OR WEALTH STRIPPING FOR OLDER PERSONS (2007), *available at* http://assets.aarp.org/rgcenter/consume/m_6_mortgage.pdf (noting that complex subprime loan products which were previously marketed to affluent borrowers are increasingly being targeted to lower income individuals who may not be able to absorb the repayment shock when interest rates reset); Jonathan Hershaff et al., Subprime Lending: Neighborhood Patterns Over Time 6 (Apr. 2005) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920847 (noting the prevalence of subprime lending in low income neighborhoods). Subprime lending was also more prevalent in minority neighborhoods. *See* JAMES H. CARR & LOPA KOLLURI, FANNIE MAE FOUND., PREDATORY LENDING: AN OVERVIEW 7 (2001), *available at* http://www.knowledgeplex.org/kp/text_document_summary/article/relfiles/hot_topics/Carr-Kolluri.pdf (discussing the impact of subprime lending on minority neighborhoods). Compounding the problem, even more borrowers with good credit, who might have qualified for traditional loan products, were steered into subprime loans. Those loans often came with significant long-term costs to the borrower, such as prepayment penalties, which stripped homeowner equity. *See* Mike Hudson & E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck with Higher-Rate Loans*, L.A. TIMES, Oct. 24, 2005, at A1 (reporting that even borrowers with good credit who would have qualified for traditional loan products were often steered into subprime loans); *see also* KEITH S. ERNST, CTR. FOR RESPONSIBLE LENDING, BORROWERS GAIN NO INTEREST RATE BENEFITS FROM PREPAYMENT PENALTIES ON SUBPRIME MORTGAGES 1 (2005) (discussing the equity stripping effect of subprime loan products); ERIC STEIN, CTR. FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 16 (2001) (discussing the cost paid in higher interest rates on subprime loans by borrowers who would have qualified for less expensive traditional loans).

borrowers' ability to repay, including limited documentation or no documentation loans; and loans requiring very little or no borrower equity, including first lien mortgage loans that tolerated piggyback loans.[107]

ARMs introduce the risk of sticker shock after the expiration of a low initial "teaser" interest rate. For example, analysis of 2/28 subprime ARMs (with a low initial interest rate in effect the first two years) made in 2006 indicated an average payment shock of 29% over the teaser-rate payment, even if short-term interest rates remained unchanged.[108] Because interest rates increased in 2006, the payment shock neared 50%.[109] Many borrowers were unable to pay the higher payments required of them, in part because their ability to repay was based on the initial low interest rate.[110]

Payment option loans introduce the risk of another form of sticker shock—increase in monthly payments upon recast of the loan. In payment option loans, the borrower may choose to make a minimum payment that does not include all accrued interest and does not include payment of principal. Some industry analysts estimate that 70% of payment option ARM borrowers made only the minimum payments allowed under their mortgage loans.[111] The accrued and unpaid interest is then added to the principal. However, when the outstanding balance reaches a certain threshold, often 115% of the original principal balance, then the payment option expires and the loan is recast to require monthly payments of both interest and principal. In its suit against Countrywide for unfair and deceptive business practices in vi-

107. *See* Complaint for Injunction & Other Relief at 2, 23–24, 28 People of the State of Ill. v. Countrywide Fin. Corp., No. 08CH22994 (Ill. Cir. Ct. June 25, 2008) [hereinafter Complaint], *available at* http://www.ag.state.il.us/pressroom/2008_06/countrywide_complaint.pdf; Ruth Simon & James R. Hagerty, *Countrywide's New Scare–'Option ARM' Delinquencies Bleed into Profitable Prime Mortgages*, WALL ST. J., Oct. 24, 2007, at C1.

108. JOINT ECON. COMM., SHELTERING NEIGHBORHOODS FROM THE SUBPRIME FORECLOSURE STORM 2 (2007), *available at* http://jec.senate.gov/archive/Documents/Reports/subprime11apr2007revised.pdf. Analysts at Credit Suisse estimate that 80% of subprime loans made in 2006 included low "teaser" rates. *Cracks in the Façade—America's Housing Market,* THE ECONOMIST, Mar. 24, 2007.

109. JOINT ECON. COMM., *supra* note 108, at 2.

110. After examining the adjustable rate loans of subprime borrowers, analysts at Credit Suisse concluded that approximately one-third of those borrowers would not have qualified for their loan if their ability to repay had been calculated based on the fully indexed rate, as opposed to the initial teaser rate. *See* Lingling Wei, *Washington Mutual to Stop Offering Certain Subprime Loans*, MARKET WATCH, July 18, 2007, http://www.marketwatch.com/story/washington-mutual-to-stop-offering-certain-subprime-loans.

111. Ruth Simon, *A Trendy Mortgage Falls from Favor*, WALL ST. J., Nov. 29, 2005, at D1.

olation of the Illinois Fairness in Lending Act, the Office of the Illinois Attorney General provides a helpful example from its investigation that illustrates how the recast of a payment option loan may cause shock to a borrower's ability to repay the loan. It found that one borrower's monthly minimum payment was $751, but the fully amortizing payment required after recast was $1,834.[112] In no documentation or low documentation loans, lenders receive no assurance that the borrower is able to afford the loan; either initially or after a reset of interest rates or recast of payments. Thus there is an inherent repayment risk. The number of subprime loans made without full documentation of income climbed from approximately 26% of subprime mortgages in 2000 to approximately 44% in 2005.[113]

Piggyback loans[114] include the risk that the borrower has very little equity in the home. In the event of a significant decline in the fair market value of the property, refinancing becomes difficult or impossible. Moreover, risk of default increases since the borrower's equity diminishes due to the market decline.[115] By the end of 2006, 32% of home purchase borrowers relied upon piggyback loans to finance their purchase.[116] An increasing number of subprime loans had loan-to-value ratios exceeding 90%.[117] High loan-to-value loans were only 6.32% of subprime loan originations in 1998, but jumped to 13.7%, 16.91%, and 13.46% in 2002, 2003 and 2004, respectively.[118]

Credit Suisse documented the widespread offering of risky loan products.[119] Focusing on the subprime market at the end of 2006,

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112. Complaint, *supra* note 107, at 35.

113. Wei Li & Keith S. Ernst, *Do State Predatory Lending Laws Work? A Panel Analysis of Market Reforms*, 18 HOUS. POL'Y DEBATE 347, 361 (2007).

114. Glenn Setzer, *Piggybacks Arouse Interest–And Concern*, MORTGAGE NEWS DAILY (Aug. 9, 2005), http://www.mortgagenewsdaily.com/892005_Piggyback_Loans.asp (A piggyback loan is "a second mortgage given at the time of a home purchase or refinance" that is intended "to allow the home buyer to acquire or refinance a home with less than a twenty percent down payment . . . but without the necessity of carrying private mortgage insurance.").

115. For further discussion and documentation of these risks, see Robert B. Avery et al., *The 2007 HMDA Data*, 94 FED. RES. BULL. A107, A117 (2008), *available at* http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf.

116. FURMAN CTR. FOR REAL ESTATE & URBAN POLICY, DECLINING CREDIT & GROWING DISPARITIES: KEY FINDINGS FROM HMDA 2007, at 2 (2008), *available at* http://furmancenter.org/files/publications/KeyFindingsfromHMDA2007FurmanCenterReport.pdf. Data reported to the Federal Reserve revealed 1.37 million junior-lien loans used to purchase homes in 2005, 1.43 million in 2006, and 600,000 in 2007. Avery et al., *supra* note 115, at A113.

117. Li & Ernst, *supra* note 113.

118. *Id.*

119. CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE (2007).

Credit Suisse's findings include the following: approximately 50% of all subprime borrowers from 2004 to 2006 provided limited documentation regarding their incomes; in 2006, 2/28 ARMs (resetting after two years) "represented approximately 78% of all subprime purchase originations . . . [and] home-buyers were primarily qualified at the introductory teaser rate rather than the fully amortizing rate."[120] Focusing on the Alt-A market (encompassing loans riskier than those in the prime market but less risky than the subprime market) at the end of 2006, Credit Suisse also found the following: 55% of borrowers in Alt-A purchase originations took simultaneous piggyback mortgages at the time of purchase; low or no documentation loans represented 81% of total Alt-A purchase originations; interest-only and option ARM loans represented approximately 62% of Alt-A purchase originations; and, adding to the risk, one year hybrid ARMs represented approximately 28% of Alt-A purchase originations, setting the stage for considerable reset risk.[121] Focusing on the overall market for mortgage products, Credit Suisse found that approximately 23% of total purchase originations in 2006 were interest-only or negative amortization mortgages; and low or no documentation loans increased from 18% of total purchase originations in 2001 to 49% in 2006.[122]

The layering of risks also occurred. Payment option ARMs layer two sets of sticker shock—one due to the interest rate reset and another due to the recast of payments. A no documentation payment option ARM then adds a third layer of risk because of an inability to assess borrowers' repayment ability. A pattern of engaging in risky practices by offering loan products that layered risks was evident in the industry generally. Approximately 83% of the payment option ARMs issued from 2004 to 2007 were underwritten without full documentation of the borrowers' income.[123]

The mortgage banking industry increasingly offered loan products with several layers of risk. The General Accountability Office examined payment option ARM loans securitized in the private label secondary market in the period 2001 through 2005 and it found an increasing number of loans with multiple layers of risk—including

120. *Id*. at 4–5.

121. *Id.* at 4. The Alt-A market constituted 20% of total originations in 2006, rising from just 5% in 2002. *Id.*

122. *Id.* at 5.

123. Bob Ivry & Linda Shen, *Washington Mutual Hobbled by Increasing Defaults on Option ARMs*, BLOOMBERG, Sept. 15, 2008, http://www.bloomberg.com/apps/news?pid=Newsarchive&sid=aNSwdt57nTBI (citing to Fitch Ratings analysts).

ARMs, payment option terms, low documentation, and piggyback loans.[124]

The most revealing evidence of the failure of principles-based regulation in ensuring safety and soundness is found in the mortgage practices of banks and thrifts. These institutions were subject to the general prohibition against unsafe and unsound banking practices, as well as the uniform guidelines cautioning against unaffordable loans, including loans made without regard to the borrower's ability to repay. The Senate Report on the Act noted that consumer protections and the desired underwriting practices were clearly not guaranteed by this system.[125]

An analysis of originations of payment option ARMs illustrates the failure of the existing regulatory regime. Industry surveys reveal that banks and thrifts, either directly or through affiliates, became primary originators of payment option ARMs.[126] Principles in the form of safety and soundness and prudent underwriting requirements, as well as regulatory guidelines warning against underwriting loans without regard to ability to repay, did not prevent these practices. Beginning in 2005, and continuing into 2007, the mortgage industry newsletter, National Mortgage News, periodically collected data on residential payment option ARM originations.[127] An examination of the identity of participants identified and the overall levels of participation revealed the following distribution of payment option ARM originations:

124. U.S. Gov't Accountability Office, Report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, GAO Report 06-1021, Alternative Mortgage Products 17 (2006) [hereinafter GAO AMP Report], *available at* http://www.gao.gov/new.items/d061021.pdf.

125. S. Rep. No. 111-176, at 14 (2010) (Conf. Rep.) (stating that the "supervision of a federal prudential regulator did not guarantee that mortgage underwriting practices were any stronger, or consumer protections any more robust").

126. *Residential Option ARM Lenders in Q4 05,* Nat'l Mortgage News, Mar. 27, 2006.

127. *See, e.g.*, Paul Muolo, *Option ARMs in Sevenfold Rise*, Nat'l Mortgage News, Dec. 5, 2005, at 1 ("Mortgage bankers funded almost $73 billion in payment-option ARMs in the third quarter of 2005, a more than sevenfold increase from the same period last year . . . ."). The figures reported payment-option ARM production disclosed to National Mortgage News by lenders. The disclosed figures are estimated to capture about 60% of the payment option ARM market. Simon & Hagerty, *supra* note 107.

TABLE 1: DISTRIBUTION OF PAYMENT OPTION ARM ORIGINATIONS

Time Period	**Market Share: Residential Payment Option ARMs Originated by Banks, Thrifts, or Affiliates**
Second Quarter 2007	52.39%[128]
Second Quarter 2006	44.19%[129]
First Quarter 2006	46.37%[130]
Fourth Quarter 2005	51.15%[131]

The mortgage practices of four large banks and thrifts—Countrywide, Washington Mutual (WaMu), Wachovia, and IndyMac—further illustrate the failings of a reliance on vague legal standards and regulatory guidance to avoid unsafe mortgage lending practices.

Evidence regarding mortgage industry practices indicates layering of several types of risky loans in the industry generally, and particularly at Countrywide.[132] In 2005 Countrywide originated a significant number of payment option ARMs, becoming the top payment option ARM lender in the United States.[133] In 2006, 91% of the payment option ARMs that Countrywide originated were "low doc" mortgages in which the borrower did not fully document income or assets.[134] In its lawsuit against Countrywide, the Office of the Illinois Attorney General alleged that Countrywide offered interest-only loan products to borrowers that qualified based on the minimum or lower non-amortizing interest-only payment, despite the fact that the interest-only payment feature expired during the first years of the loan—leaving borrowers unable to afford the loan.[135] In testimony before the Senate Banking Committee, the General Counsel of Countrywide acknowledged that 60% of its borrowers who obtained hybrid ARMs would not be able to qualify at the fully indexed rate even if interest rates did not rise.[136] In 2006, Countrywide decided to switch from a

128. *Residential Option ARMs Lenders in Q2 2007,* NAT'L MORTGAGE NEWS, Oct. 1, 2007, at 1.
129. *Residential Option ARM Lenders in Q2 '06,* NAT'L MORTGAGE NEWS, Sept. 18, 2006, at 1.
130. *Residential Option ARM Lenders in Q1 '06,* NAT'L MORTGAGE NEWS, July 24, 2006, at 1.
131. *Residential Option ARM Lenders in Q4 '05,* NAT'L MORTGAGE NEWS, Mar. 27, 2006, at 1.
132. *See* Simon & Hagerty, *supra* note 107 (noting that Countrywide was the largest ARM lender in 2005 and that a significant number of its ARMs were low documentation and piggyback mortgages).
133. *Id.*
134. *Id.*
135. Complaint, *supra* note 107, at 35.
136. S. REP. NO. 111-176, at 13 (2010) (Conf. Rep.).

national bank charter to a national thrift charter in order to be regulated by the OTS, specifically because the OTS applied the interagency guidelines on alternative mortgage products with "more restraint."[137]

WaMu similarly embraced risky loan practices. The FDIC's Office of Inspector General found that "option ARMs represented as much as half of all loan originations [at WaMu] from 2003 to 2007 and approximately $59 billion, or 47%, of the home loans on WaMu's balance sheet at the end of 2007."[138] WaMu originated a significant number of stated-income loans, in which they did not verify the borrower's income.[139] According to the FDIC's Office of Inspector General, approximately 90% of all of WaMu's home equity loans, 73% of payment option ARMs, and 50% of subprime loans were stated-income loans.[140] WaMu underwrote payment option ARM loans based on the borrower's ability to afford the low initial teaser payment through at least 2007.[141]

The biggest originators of payment option ARM loans in 2007 were Wachovia, WaMu, Countrywide, Downey Financial Corp. (a savings and loan), and IndyMac.[142] Wachovia was the largest originator of payment option ARM loans in the second quarter of 2007, followed by WaMu, holding $122 billion of such loans.[143] Wachovia was also the largest holder of payment option ARMs. According to its website, such mortgages represented 73% of Wachovia's loan portfolio.[144] Wachovia purchased Golden West Financial Corp. in 2006 in part because it hoped to sell Golden West's payment option adjustable rate mortgages to its own customers.[145]

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137. Barbara A. Rehm, *Countrywide to Drop Bank Charter in Favor of OTS*, AM. BANKER, Nov. 10, 2006, at 1.

138. OFFICES OF INSPECTOR GEN., REPORT NO. EVAL-10-002, EVALUATION OF FEDERAL REGULATORY OVERSIGHT OF WASHINGTON MUTUAL BANK 9 (2010) [hereinafter OVERSIGHT OF WASHINGTON MUTUAL], *available at* http://www.fdicoig.gov/reports10/10-002EV.pdf.

139. *Id.* at 10.

140. *Id.*

141. Michael Hudson & Jim Overton, CTR. FOR RESPONSIBLE LENDING, THE SECOND S&L SCANDAL 8 (2009), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/the-second-s-l-scandal.pdf, (citing data collected from WaMu's filings with the SEC).

142. *Id.*

143. Ivry & Shen, s*upra* note 123.

144. Bob Ivry, *Wachovia Option–ARM Mortgage Losses May Force Merger*, BLOOMBERG, Sept. 29, 2008, http://www.bloomberg.com/apps/news?sid=af4TVTdVFB1s&pid=newsarchive.

145. Matthias Rieker, *What's Driving Latest Deals? (It's Not Costs)*, AM. BANKER, May 15, 2006, at 1.

IndyMac maintained similar practices[146] and was one of the largest holders of payment option ARM loans.[147] As recently as the first quarter of 2007 only 21% of IndyMac's total loan production was in the form of full documentation mortgages.[148] Some of the loans that IndyMac labeled as full documentation loans were only supported by verification of employment, and lacked any verification of income.[149]

In time, unsafe products provided by the mortgage market led to a significant number of foreclosures.[150] Concerns over safety and soundness in banking legislation runs parallel with concern over the safety of depository institutions and the FDIC, as well as repercussions for the economy due to concerns over bank safety and the availability of credit. From this perspective, principles-based regulation disserved legislative purposes. U.S. depository institutions suffered tens of billions of dollars of losses on one- to four-family mortgage loans.[151] The United States experienced 140 bank failures in 2009, the largest number of failures since 168 institutions failed in 1990, costing the FDIC fund $35.6 billion.[152] As a result of losses and projected losses due to bank failures, both the fund balance and the reserve ratio at the FDIC was negative as of September 30, 2009, the first time the fund balance was negative since the banking crisis in the late 1980s and early 1990s.[153] Failures did not abate in 2010; between January 2009 and December 2010, 297 banks failed.[154] By the end of 2009,

146. OFFICE OF INSPECTOR GEN., OIG-09-032, MATERIAL LOSS REVIEW OF INDYMAC BANK, FSB (summarizing IndyMac's lending practices and concluding that because it did not always verify income or credit history, and because IndyMac offered an array of nontraditional loan products, loans were made to many borrowers that could not afford to make payments).

147. Ivry, *supra* note 144; Ivry & Shen, *supra* note 123 (When IndyMac was seized by regulators, it held $3.5 billion of option ARMs. IndyMac's portfolio of option ARMs made it the fifth largest holder of option ARMs , behind Wachovia, WaMu, Countrywide, and Downey Financial.).

148. MIKE HUDSON, CTR. FOR RESPONSIBLE LENDING, INDYMAC: WHAT WENT WRONG? HOW AN "ALT-A" LENDER FUELED ITS GROWTH WITH UNSOUND AND ABUSIVE MORTGAGE LENDING 3 (2008), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/indymac_what_went_wrong.pdf (utilizing SEC filings).

149. *Id.* at 8.

150. *See infra* Part I.C.2.

151. *See* Statement of Sheila C. Bair, *supra* note 102 ("Net chargeoffs of 1- to 4-family mortgages and home equity lines of credit by FDIC-insured institutions over the past two years have totaled more than $65 billion.").

152. *Quarterly Banking Profile: Fourth Quarter 2009*, *supra* note 102, at 16.

153. Statement of Sheila C. Bair, *supra* note 102 ("The FDIC projects that over the period 2009 through 2013 the fund could incur approximately $100 billion in failure costs . . . [with] most of these costs [occurring] in 2009 and 2010.").

154. INQUIRY REPORT, *supra* note 102, at 401.

the FDIC fund balance was at a record low—negative $20.9 billion.[155] By June 30, 2010 it had recovered somewhat but was still at negative $15.3 billion.[156] The legislative interest in maintaining the safety and soundness of banking institutions is also a concern about credit access and the overall health of the U.S. economy.[157]

2. Access to Credit

Congress repeatedly voiced its embrace of access to credit as a goal for the mortgage markets.[158] Regulators praised the availability of subprime loans and innovative mortgage products (e.g., ARMs, payment option loans, interest-only loans, and no documentation loans) because of the resulting macroeconomic benefits, such as increased levels of homeownership.[159] Overall levels of homeownership increased from 67.4% of all U.S. households in 2000 to 68.9% in 2005.[160] Among all minority homeowners, the rate of homeownership increased from 48.1% in 2000 to 51.3% in 2005.[161] A principles-based regulatory regime appeared to serve the legislative purpose of access to credit, but such gains in homeownership were short-term. Foreclosures due to the risky nature of such loans soon eliminated the gains in rates of homeownership.

Foreclosures reflect three stages of risk created by the mortgage practices of recent years. The first wave of foreclosures in mid-2006

155. *Quarterly Banking Profile: Third Quarter 2010*, 4 FDIC Q. 4, 17 (2010).

156. *Id.*

157. S. Rep. No. 111-176, at 39 (2010) (Conf. Rep.) (linking the mortgage crisis to a rise in unemployment).

158. Garn St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320 §§ 802-05, 96 Stat. 1469, 1545–47 (1982) (codified as amended in scattered sections of 12 U.S.C.); Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Pub. L. No. 102-550, § 1302(7), 106 Stat. 3941, 3942 (1992) (codified at 12 U.S.C. § 4501(7)); S. Rep. No. 97-641, at 87–88 (1982) (Conf. Rep.); *see also* S. Rep. No. 97-536, at 15 (1982) (Conf. Rep.) ("[T]he purpose of federal thrift institutions is to provide . . . for the extension of credit for homes and for other goods and services.").

159. Edward M. Gramlich, Governor, Bd. of Governors of the Fed. Reserve Sys., Subprime Mortgage Lending: Benefits, Costs and Challenges, Remarks at the Financial Services Roundtable Annual Housing Policy Meeting, May 21, 2004, *available at* http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm (describing the increased rates of homeownership, particularly among minority and low-income communities).

160. *See* Joint Ctr. for Hous. Studies of Harvard Univ., The State of the Nation's Housing: 2009 37 (2009) [hereinafter Joint Ctr. 2009], *available at* http://www.jchs.harvard.edu/publications/markets/son2009/son2009.pdf.

161. *Id.*

and accelerating in 2007 resulted from subprime ARMs.[162] The second wave, through 2007 and 2008, resulted from Alt-A loans with risky loan terms including ARMs, limited or no documentation requirements as well as interest-only or optional payment terms.[163] A third wave of foreclosures overlapped the second and has continued thereafter. It resulted from a sharp drop in housing prices, making refinancing of a large outstanding mortgage balance impossible, as well as adverse economic conditions including job losses and tightening of credit.[164]

Foreclosures that result from unsafe products and practices have increased significantly in recent years. The foreclosure rate in subprime loans exceeded 5% from 2001 to 2003 and then again in the first quarter of 2007.[165] It never dropped below 3% in the 2001 to 2007 period.[166] Total loans in foreclosure averaged 455,000 annually in the period 2002 to 2006, and then more than doubled to nearly 940,000 by the fourth quarter of 2007.[167] From the start of the mortgage crisis to the end of 2010, approximately four million households lost their homes to foreclosure.[168] It is estimated that the total number of foreclosures resulting from the mortgage crisis will be between eight and thirteen million.[169] As a result, millions of individuals lost homes and home equity. Neighboring homes and communities' equity fell as well. As of the end of 2010, 10.8 million households nationwide, or 22.5% of those with mortgages, owe more on their mortgages than the market value of their homes.[170]

Two troubling characteristics are apparent from the recent foreclosure crisis. First, foreclosures are heavily concentrated in low-in-

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162. *See* Inquiry Report, *supra* note 102, at 216; U.S. Dep't of Hous. & Urban Dev., 111th Cong., Report on the Root Causes of the Foreclosure Crisis 4–7, 9 (2010) [hereinafter Root Causes]; Yuliya S. Demyanyk, *Quick Exits of Subprime Mortgages*, 91 Fed. Res. Bank of St. Louis Rev. 79, 91 (2009).

163. *See* Root Causes, *supra* note 162, at 7–9, 17 (discussing the segment of the market that the Mortgage Bankers Association data characterizes as prime but that actually consisted of the Alt-A market).

164. *See id.* at 13, 15, 18–20, 29 (discussing dramatic fall in house prices); *id.* at 21 (describing economic conditions that have contributed to worsening of the mortgage crisis).

165. Darryl E. Getter, Cong. Research Serv., Understanding Mortgage Foreclosures: Recent Events, The Process, and Costs 3 (2007), *available at* http://wassermanschultz.house.gov/RL34232.pdf.

166. *Id.*

167. Joint Ctr. 2008, *supra* note 104, at 20.

168. Inquiry Report, *supra* note 102, at 402.

169. *Id.*

170. *Id.* at 403.

come communities.[171] This is understandable because lower-income borrowers were least likely to have been able to afford the payment shocks triggered by innovative mortgage products. The adverse impact of a foreclosure was also more pronounced for low-income residents because housing constitutes a very large component of wealth, approaching or exceeding 50%, of total family wealth.[172] Price declines in the market value of homes in low-income areas have been, in some communities, more precipitous than in other areas facing foreclosures.[173] The number of foreclosured homes and the resultant price declines produced by such foreclosures continues to threaten neighborhood stability.[174]

The second trend that is discernible from the recent foreclosure crisis is that foreclosures occur disproportionately in predominantly African-American or Hispanic communities.[175] Studies and reports

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171. *Neighborhoods: The Blameless Victims of the Subprime Mortgage Crisis: Hearing Before the Domestic Policy Subcomm. of the H. Comm. on Oversight and Gov't Reform*, 111th Cong. 29–41, 34 (2008) [hereinafter Statement of Vicki Been] (statement of Vicki Been, New York University School of Law); Kelley D. Edmiston, *Characteristics of High Foreclosure Neighborhoods in the Tenth District*, 94 FED. RES. BANK OF KANSAS CITY 51, 56 (2009); Jennifer Bjorhus, *Foreclosure Threat Reaches the Burbs*, ST. PAUL PIONEER PRESS, Dec. 3, 2006, at 1A (noting that Twin Cities foreclosures "have been most concentrated in lower-income urban neighborhoods"); Jackie Crosby et al., *Twin Cities Troubled by Multiplying Foreclosures*, STAR TRIBUNE, Nov. 26, 2006, at 1A ("A disproportionate number of foreclosures are in low-income neighborhoods . . . ."); Elizabeth Laderman & Carolina Reid, *Lending in Low- and Moderate- Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown* 14 (Fed. Res. Bank of S.F.,Working Paper No. 2008-05-14, 2008) ("Loans located in low-income tracts were 2.7 times more likely to be in foreclosure than those in upper-income tracts . . . . ").

172. Brian K. Bucks et al., *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, FED. RES. BULL. A1, A33 (2009).

173. *E.g.*, SACRAMENTO HOUS. & REDEV. AGENCY, FORECLOSURE AND SUBPRIME MORTGAGE CRISIS: SACRAMENTO RESPONSE 4 (2008), *available at* http://shra.org/LinkClick.aspx?fileticket=U5C0AtdIWCk%3D&tabid=103&mid=454 (documenting price declines in low-income areas); GEOFF SMITH & SARAH DUDA, WOODSTOCK INST., ROADBLOCK TO RECOVERY: EXAMINING THE DISPARATE IMPACT OF VACANT LENDER-OWNED PROPERTIES IN CHICAGO 7 (2009) (documenting price declines in Chicago in areas with high percentage of African American residents). Both studies found that price declines were twice as great in low-income and minority areas.

174. CRAIG HELMSTETTER, AMHERST H. WILDER FOUND., AFFORDABLE HOUSING FOR LOW-INCOME FAMILIES: THE IMPACT OF THE RECESSION AND FORECLOSURES IN THE TWIN CITIES 3 (2008), *available at* http://www.wilder.org/reportsummary.0.html?tx_ttnews%5Btt_news%5D=2113 (claiming that clusters of foreclosures can deteriorate a neighborhood).

175. DEBBIE GUIENSTEIN BOCIAN ET AL., CTR. FOR RESPONSIBLE LENDING, UNFAIR LENDING, THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 3 (2006); CARR & KOLLURI, *supra* note 106, at 6; HELMSTETTER, *supra* note 174, at 3; ERIC STEIN, CTR. FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 12 (2001); Debbie Goldstein & Stacy Strohauer Son,

concerning foreclosures in the New York City region,[176] Boston,[177] Chicago,[178] Baltimore,[179] Minneapolis-St. Paul,[180] Cleveland,[181] San Diego,[182] and Durham County, North Carolina,[183] for example, all document that foreclosures are highly concentrated in minority neighborhoods and lower-income neighborhoods.

Why Prepayment Penalties are Abusive in Subprime Home Loans 7 (Ctr. for Responsible Lending, Policy Paper No. 4, 2003).

176. Statement of Vicki Been, *supra* note 171, at 81.

177. Kristopher S. Gerardi & Paul S. Willen, *Subprime Mortgages, Foreclosures, and Urban Neighborhoods* 14 (Fed. Reserve Bank of Boston, Public Policy Discussion Paper No. 08-6, 2008), *available at* http://www.bos.frb.org/economic/ppdp/2008/ppdp0806.pdf (In the current housing crisis, foreclosures are highly concentrated in minority neighborhoods, even relative to past foreclosure booms, such as the crisis of the early 1990s).

178. Geoff Smith, Woodstock Inst., Foreclosures in the Chicago Region Continue to Grow at an Alarming Rate 4, 6 (2008), *available at* https://www.policyarchive.org/handle/10207/18298 (finding that, in 2007, census tracts in Chicago that were at least 80% minority had 2.5 times greater foreclosure levels than the greater six county region); *see also* Smith & Duda, *supra* note 173, at 4 (Communities that were at least 80% African American had unsold single-family REOs that were two times greater than Chicago's and 7.5 times greater than communities that were less than 50% minority.).

179. Complaint for Declaratory & Injunctive Relief & Damages at 2, Mayor of Baltimore v. Wells Fargo Bank, 631 F. Supp. 2d 702 (D. Md. 2009) (No. 08–cv-00062) (describing the effects of Wells Fargo's lending practices on African American neighborhoods in Baltimore).

180. Mark Ireland, Kirwan Inst. for the Study of Race & Ethnicity, Bending Toward Justice: An Empirical Study of Foreclosures in One Neighborhood Three Years After Impact and a Proposed Framework for a Better Community 11 n.11, *available at* http://4909e99d35cada63e7f757471b7243be73e53e14.gripelements.com/FairHousing_FairCredit/mark_ireland_bending_toward_justice_merge.pdf (finding that in North Minneapolis, a lower-income community in which most residents are people of color, "the foreclosure rate as a percentage of households was approximately six times higher than Hennepin County and four times higher than Minneapolis."); Bjorhus, *supra* note 171; Jackie Crosby et al., *supra* note 171.

181. Vikas Bajaj & Ron Nixon, *For Minorities, Signs of Trouble in Foreclosures*, N.Y. Times, Feb. 22, 2006, at A1 ("In the eastern part of [Cleveland], which is 52 percent black and 7 percent Hispanic, the ratio of [foreclosure] auctions to regular sales was 23 per 100 last year, up from 9 in 1995. In the west, which is 82% white, the ratio was 11 per 100, up from 2.5.").

182. San Diego Reinvestment Task Force, Analysis and Response to Foreclosures in Low-Moderate Income Communities of San Diego 5 (2007), *available at* http://www.frbsf.org/community/issues/assets/preservation/resources/foreclosure_report.pdf (finding an ongoing increase in foreclosures of single-family homes with highest concentrations in low-income and ethnic dominant census tracts and predominantly subprime products).

183. Adam Rust & Peter Skillern, The Cmty. Reinvestment Ass'n of N.C., Empty Houses and Broken Dreams 5 (2008) *available at* http://archive.cra-nc.org/files/Download/ForeclosuresJuly2008.pdf (more than 78% of all homes in foreclosure in Durham County were resided in by African Americans).

Comparing the recent foreclosure experience with experience in earlier periods (before the introduction of innovative loan products and the increased offering of subprime loans) reveals that lower-income households are more likely to miss payments and default on their mortgages.[184] However, the rate of foreclosures in low-income communities in the early- and mid-1990s was only slightly higher than for high-income borrowers.[185] More recent comparative studies of default and foreclosure rates among borrowers holding innovative mortgage loan products compared with traditional mortgage products similarly found a low default and foreclosure rate among low-income borrowers who received traditional mortgage loans.[186]

Some argue that innovative and subprime mortgage products increase rates of homeownership and thus provided a net societal benefit.[187] Even if a net increase in homeownership was the outcome, it is a troubling ethical viewpoint to claim that losses suffered by many homeowners due to the high-risk nature of the products they were offered, especially low-income homeowners, are justified because of an overall gain in nationwide levels of homeownership. Such an outcome also disserves the legislative goal of equal opportunity in access to credit. Furthermore, evidence reveals that these products result in no

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184. *See generally* INQUIRY REPORT, *supra* note 102, at 488 (finding that government policies advocating for increased lending to low-income borrowers was a contributing factor in the recent financial crisis).

185. CHRISTOPHER E. HERBERT & ERIC S. BELSKY, U.S. DEP'T OF HOUS. & URBAN DEV., THE HOMEOWNERSHIP EXPERIENCE OF LOW-INCOME AND MINORITY HOUSEHOLDS: A REVIEW AND SYNTHESIS OF THE LITERATURE 46–47 (2006).

186. *E.g.*, Gretchen Morgenson, *Blame the Borrowers? Not So Fast*, N.Y. TIMES, Nov. 25, 2007, B1 (comparing loans made by Neighborhood Housing Services of America (NHSA), in which borrowers' income averaged less than two-thirds of the national median income, with subprime loans and finding that as of June 30, 2007, 3.34% of NHSA borrowers were at least 30 days delinquent on their loans, a rate only slightly higher than the 2.63% delinquency rate on prime loans and far lower than the 14.54% delinquency rate on subprime loans nationwide; NHSA loans that went into foreclosure during the second quarter of 2007 totaled 0.56%, compared with an 0.25% rate for prime loans and 2.45% rate for subprime loans; the NHSA borrowers did not meet conventional credit standards in addition to being of low or moderate income). Subsequent analysis of foreclosure rates on loans made to NHSA borrowers confirmed these conclusions. Neil Bhutta, *Did the CRA Cause the Mortgage Market Meltdown?* COMMUNITY DIVIDEND, Mar. 1, 2009, 7 tbl. 6, *available at* www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4136 (indicating that foreclosures started on single-family first mortgage home loans between April 1, 2008 and June 30, 2008 indicate foreclosure rate of 0.61% on all prime loans and 0.21% on NHSA loans).

187. *See* JOINT CTR. 2008, *supra* note 104, at 3 (acknowledging that "subprime loans and new types of mortgages have been linked to a temporary increase in homeownership . . . .").

long-term net societal benefits in the form of increased levels of homeownership.[188]

The Center for Responsible Lending analyzed the claimed net gain in homeownership resulting from subprime lending from 1998 to 2006. It concluded that, "subprime loans made during 1998–2006 led or will lead to a net loss of homeownership for almost one million families.[189] This conclusion followed from the fact that between 1998 and 2006 approximately 1.4 million first time home buyers purchased homes using subprime loans but an estimated 2.2 million borrowers who obtained subprime loans will lose or have already lost their homes to foreclosure.[190] The calculations made by the Center for Responsible Lending do not take into account the even greater number of foreclosures that occurred after 2006, which will further increase the net loss in homeownership produced by subprime loan products.

The Center for Responsible Lending's data focused on the net effect of subprime loans on homeownership. By contrast, the Joint Center for Housing Studies of Harvard University examined the overall rates of homeownership in the United States and found that they declined to pre-2001 levels—before most innovative loan products became prevalent.[191] The Harvard study does not account for further losses due to foreclosures in 2009 and subsequent years.

Overall levels of homeownership among minority homeowners similarly declined to the pre-2004 levels, while black homeownership declined to pre-2001 levels. Considered in unison with the Center for Responsible Lending's analysis of the substantial net decline in homeownership produced by subprime loans, the reasonable conclusion is that such innovations produced far more harm than good. The Joint Center for Housing Studies came to the same conclusion in its 2008

188. NET DRAIN, *supra* note 103 at 2.

189. *Id.*; *see also* Demyanyk, *supra* note 162, at 92 (examining a database of subprime mortgages in the period 2001–2008 and finding a net homeownership loss occurs in subprime loans made in every one of the past nine years).

190. NET DRAIN, *supra* note 103, at 2. A majority of subprime loans were refinances and not for purchase of a home. Moreover, a significant proportion of subprime purchase mortgages are obtained by existing homeowners buying another home, rather than first-time home-buyers, and therefore do not increase homeownership levels. There is evidence in the literature that a substantial number of first-time homeowners return to renter status within five years of homeownership. *See* HERBERT & BELSKY, *supra* note 185, at 51. However, this would only lead to the conclusion that total gains in homeownership should be about one-half of the initial gains in the long-term. It does not lead to a significant net loss in homeownership, which resulted from recent innovative loan products.

191. JOINT CTR. 2009, *supra* note 160, at 4; *see also* Paul S. Calem et al., *Sustainable Homeownership* 2 (Wharton Sch. Zell/Lurie Real Estate Ctr., Working Paper No. 643, 2009), *available at* http://ssrn.com/abstract=1365436.

report on the state of the nation's housing.[192] By the fall of 2010, the rate of homeownership dropped to 66.9%, falling below the 1999 rate of homeownership.[193]

There were no long-term gains in homeownership resulting from innovative loan products. Moreover, there is a possibility of eight million additional foreclosures in coming years,[194] further undermining the goal of access to credit leading to homeownership.

3. Unfair Loan Products and Practices

A third goal for mortgage market operations repeatedly voiced by Congress was preventing unfair products and practices. But in the last decade, significant numbers of unfair mortgage loans were underwritten in a principles-based regulatory regime. These products and practices stripped equity from consumers. The parts focus on the following three unfair products and practices: (a) charging consumers excessive interest rates,[195] (b) charging consumers excessive fees and prepayment penalties, and (c) forced refinancing and loan flipping.

a. Excessive Interest Rates

The practice of charging excessive interest rates arose, in part, by lenders providing subprime loan terms to borrowers that would otherwise qualify for prime loans. Freddie Mac discovered this phenomenon in 1996 when it analyzed subprime loans for the purpose of testing a proposed automated underwriting program. It found that between 10% and 35% of borrowers who obtained mortgages in the subprime market could have qualified for a conventional loan.[196] Fannie Mae came to a similar conclusion in its analysis of subprime loans.[197]

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192. JOINT CTR. 2008, *supra* note 104, at 4 (finding that innovative mortgage loan products decreased overall levels of homeownership to pre-2003 levels).

193. INQUIRY REPORT, *supra* note 102, at 392 (finding that the homeownership rate declined from its peak of 69.2% in 2004 to 66.9% as of the fall of 2010).

194. *Id.* at 402.

195. For purposes of this article, interest rates, fees, and prepayment penalties are excessive when the amounts are not justified based on credit risk and underwriting costs.

196. Peter E. Mahoney & Peter M. Zorn, *The Promise of Automated Underwriting,* 1996 MORTGAGE MARKET TRENDS 22 (1996); *see also* Hudson & Reckard, *supra* note 106 ("Freddie Mac, the government-sponsored mortgage finance giant, estimates that more than 20% of people who get those so-called sub-prime loans could have qualified for more conventional prime loans.").

197. CARR & KOLLURI, *supra* note 106, at 7 (citing Fannie Mae) (estimating that as many as fifty percent of borrowers in the subprime market could qualify for prime market loans).

The introduction of automated underwriting programs could have helped institutions better identify creditworthy borrowers and minimize the frequency of excessive interest rates; however, it did not. More recent analysis of the subprime mortgage market indicated that the number of borrowers subjected to this unfair lending practice arguably increased.[198] In an analysis of more than $2.5 trillion subprime loans made since 2000 the Wall Street Journal reported that, in 2005, 55% of borrowers with credit scores that would have qualified them for prime mortgages received subprime mortgages instead.[199] This percentage was 41% in 2000, and it rose to 65% in 2006.[200]

Another group of loans subject to excessive interest rates are those where bona fide subprime borrowers pay excess interest rates due to a reliance on mortgage brokers.[201] In recent years, mortgage brokers originated more than half of all prime and subprime mortgage loans.[202]

As early as 1996, Freddie Mac reported that subprime borrowers who would have qualified for prime loans pay mortgage rates on the order of 1% to 2.5% higher in the subprime market.[203] An additional study by Freddie Mac found that 1% of the overall interest rate charged on such subprime loans could not be explained by credit risk.[204]

Based on such evidence of rate risk disparity in subprime lending, the Center for Responsible Lending calculated the loss to consumers from excess interest charges.[205] Based on subprime originations in 2000, the cost to subprime borrowers who would have qualified for

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198. *See* STEIN, *supra* note 106, at 4; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-848R, CHARACTERISTICS AND PERFORMANCE OF NONPRIME MORTGAGES 3 (2009) [hereinafter NONPRIME MORTGAGES].

199. Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy; As Housing Boomed, Industry Pushed Loans To a Broader Market*, WALL ST. J., Dec. 3, 2007, at A1.

200. *Id.*

201. KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, STEERED WRONG: BROKERS, BORROWERS, AND SUBPRIME LOANS 3 (2008) (finding that subprime lenders were consistently charged higher interest rates when they received a loan through a mortgage broker).

202. U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING 39–40 (2000) [hereinafter CURBING PREDATORY HOME MORTGAGE LENDING], *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf (citing National Association of Mortgage Brokers, who found that brokers originate over half of all mortgage loans).

203. Mahoney & Zorn, *supra* note 196, at 22.

204. Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUS. POL'Y DEBATE 533, 569 (2000).

205. STEIN, *supra* note 106, at 16–17.

prime loans would be $2.9 billion per year.[206] As noted above, subprime borrowers who would not likely qualify for prime loans also pay higher interest rates when they receive their loan through a broker. Thus, a similarly large annual loss in the form of excess interest payments would exist due to rate disparities in subprime brokered loans.

Even more troubling than the unfair practice of charging excessive interest to consumers is evidence that certain vulnerable groups were targeted for unfair loan products. The groups found to be targeted are the elderly, minority borrowers, and low-income borrowers. AARP reported that borrowers aged sixty-five or older were three times more likely to hold subprime mortgages than borrowers less than thirty-five years of age.[207] Researchers have also found that minority status, in particular the percentage of African-American households, continues to be strongly associated with subprime lending, even after holding other variables constant.[208] Similarly, researchers at Fannie Mae found that subprime loans are three times more likely in low-income neighborhoods than in high-income areas, and five times more likely in African-American neighborhoods than in white neighborhoods.[209] The disparate treatment is not explained by differences in credit risk.[210]

Principles-based regulations failed to prevent unfair products and practices in the form of excessive interest rates. Rather, imposition of excessive rates went unchecked and even increased in frequency during the last decade.

b. Excessive Fees and Prepayment Penalties

Excessive charges are imposed on consumers in two forms. First, fees charged at loan origination may be excessive in relation to underwriting costs or expected returns based on interest rates charged. Second, excessive prepayment penalties may be imposed.

As documented above, a substantial number of borrowers who may qualify for prime mortgages are given subprime mortgages by originators.[211] The cost of such subprime loans is not only the higher

206. *Id.* This conservatively assumes 20% of subprime borrowers would qualify for prime loans.
207. HERMANSON, *supra* note 106, at 2.
208. Hershaff, *supra* note 106, at 16.
209. CARR & KOLLURI, *supra* note 106, at 6.
210. *Id.* at 6–7; *see also* BOCIAN ET AL., *supra* note 175 at 3 (finding that African-American and Latino borrowers are at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors, and that the disparities are large and statistically significant).
211. *See* Brooks & Simon, *supra* note 199.

interest rates, as documented above, but also higher origination fees.[212] In 1999, excess up-front fees paid by subprime borrowers would total an estimated $800 million per year and affect 600,000 borrowers.[213] As this volume increased in later years the total excess cost imposed on consumers also increased.[214]

Prepayment penalties are another source of excessive fees imposed upon borrowers. Prepayment penalties were levied on less than 2% of prime mortgages but up to 50% of subprime mortgages in the period from 2001 to 2002.[215] The frequency with which prepayment penalties were charged increased in later years and was disproportionately imposed in subprime loans.[216]

Lenders argue that prepayment penalties are charged in exchange for lower interest rates granted to consumers and therefore justified by such lower rates.[217] However, one study found that, in subprime purchase loans, borrowers with prepayment penalties actually paid higher interest rates than similarly situated borrowers without prepayment penalties.[218] In subprime refinance loans, imposition of prepayment penalties produced no statistically significant difference in interest rates.[219] A later study similarly found that interest rates on mortgages with prepayment penalties are higher than those without.[220]

212. STEIN, *supra* note 106, at 7 n.17, 14–15 (documenting the higher average up-front cost of subprime loans as compared to conventional loans); *see also* ERNST ET AL., *supra* note 201, at 8–9; Mahoney & Zorn, *supra* note196, at 22; CURBING PREDATORY HOME MORTGAGE LENDING, *supra* note 202, at 28; Zorn, *supra* note 204, at 540.

213. STEIN, *supra* note 106, at 15.

214. NONPRIME MORTGAGES, *supra* note 198, at 6 (reporting that subprime originations increased more than fivefold from 2000 to 2005).

215. Li & Ernst, *supra* note 113, at 361 (finding that in every year from January 1998 until March 2005, at least 50% of subprime loans contained prepayment penalties); Goldstein & Son, *supra* note 175, at 2 (utilizing data reported by Standard & Poor's and Freddie Mac).

216. Truth In Lending, 73 Fed. Reg. 44,522, 44,553 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) (From 2003 to mid-2007, just 6% of prime loans contained prepayment penalties, while close to 75% of subprime loans contained prepayment penalties).

217. ERNST, *supra* note 106, at 1.

218. *Id.*

219. *Id.*

220. Michael S. Barr et al., *Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low- and Moderate-Income Neighborhoods* (Apr. 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=%201121215 (finding a median APR of 7% for loans with prepayment penalties vs. 6.5% for loans without prepayment penalties). Various additional studies concerning the rate reduction, if any, generated by imposition of prepayment penalties are discussed by the Federal Reserve. Truth in Lending, 73 Fed. Reg. at 44,554.

Thus, such prepayment penalties were not justified in economic terms as an exchange for lower interest rates.

The Center for Responsible Lending calculated the costs of prepayment penalties to consumers.[221] First, it calculated the cost of the higher interest rates charged in loan originations to borrowers who also were subjected to prepayment penalties and found the lifetime cost in excess interest would be $881 million, affecting 380,000 borrowers in 2003.[222] Next, it calculated the cost of the prepayment penalty itself, which amounted to a loss of $2.3 billion each year and affected approximately 850,000 families.[223] As subprime loans increased in later years, the costs to consumers also increased.

One final troubling finding associated with prepayment penalties is that they increase the likelihood of foreclosure. After controlling for other factors, researchers found that loans with prepayment penalties are 20% more likely to experience foreclosure than other loans.[224] This is because prepayments may preclude the ability to cure a default through refinancing.[225] Researchers also confirmed that some groups are targeted for excessive fees and prepayment penalties, or at least are disproportionately impacted by such practices, confirming the correlation between minority status and unfair credit terms.[226]

The Act limits prepayment penalties for future mortgage loans.[227] It does not completely forbid such prepayment penalties, however, and does not address the issue of excessive interest rates and fees imposed on borrowers.

221. Ernst, *supra* note 106, at 4–5.

222. *Id.* at 1.

223. Goldstein & Son, *supra* note 175, at 3.

224. Roberto G. Quercia et al., *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, 18 Hous. Pol'y Debate 311, 337 (2007).

225. *See id.* at 317–18, 333 (reasoning that prepayment penalties increase default risk).

226. Barr et al., *supra* note 106, at 2, 9–10 (finding that black homeowners in Detroit area are significantly more likely to have prepayment penalties attached to their mortgages than non-black homeowners, and that black borrowers pay more than twice the amount of fees than white borrowers).

227. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1414(a), 124 Stat. 1376, 2149–52 (2010) (amending 15 U.S.C. § 1639c).

c. Refinancing and Loan Flipping

Equity stripping arises when refinancing is forced upon borrowers due to ARMs or recast of payment option loans, and when refinancing occurs, due to loan flipping.[228]

Refinancing required by innovative mortgage products, such as ARMs and payment option loans, take a toll on homeowners' equity. Each refinancing strips equity from the homeowner due to the fees and costs incurred. These include the cost of the points paid on the new loan; fees charged by the lender to complete each refinancing, such as appraisal fees and lender attorney's fees; fees charged by third parties necessitated by the refinancing, such as title insurance searches and fees in connection with the mortgage title insurance policy; and, in some states, mortgage recording taxes.

At times lenders may offer refinancing of loans with "no closing costs." But at Countrywide, for example, consumers that received refinancing with "no closing costs" were charged higher interest rates,[229] similarly stripping additional equity from the consumer.

Loan flipping is another form of refinancing and is abusive when the refinancing is not in the borrowers' interest. A review of thousands of subprime loans led to the conclusion that approximately 15% of all subprime refinancing did not benefit the borrower in economic terms.[230] The most onerous example is when a borrower is convinced to substitute a high-priced mortgage loan for a low-priced mortgage loan that might be guaranteed or subsidized by federal or state government. Researchers in North Carolina found that lenders convinced one in ten Habitat for Humanity borrowers to refinance their zero percent first mortgages into high interest subprime loans.[231]

The estimated costs to borrowers in the form of closing costs and fees imposed for refinancings that were not in the borrowers' best interest—they did not benefit the borrower in economic terms—amounted to $960 million per year in excess fees paid by 150,000 borrowers in 1999.[232] Refinancing of subprime increased substantially since 1999, resulting in an even greater cost to consumers.[233] Of

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228. *See* Complaint, *supra* note 107, at 36, 73 (describing the relationship between loss of equity and option ARMs).

229. *Id.* at 61.

230. Stein, *supra* note 106, at 15.

231. Ctr. for Responsible Lending, Frequently Asked Questions on Habitat Refinances 2 (June 21, 1999), http://www.responsiblelending.org/mortgage-lending/tools-resources/state/north-carolina/faq-on-hb1817.html.

232. Stein, *supra* note 106, at 15.

233. *Id.* at 4.

course, this calculation does not measure the additional costs of higher interest rates that may be generated by such refinancing.

II.
The Dodd-Frank Act and a Return to Rules-Based Regulation

A. *An Alternative Regulatory Regime: Initial Analysis*

Title 14 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) embraces an alternative regulatory regime, one relying on more detailed prescriptive rules (rules-based regulation) to achieve legislative purposes. It was preceded by a similar change in regulatory approach by the Board of Governors of the Federal Reserve System (the Board).[234] The FSA also proposed a shift in regulatory approach by imposing some additional rules. The proposals include requirements that lenders verify income for all applicants, assess an applicant's ability to repay a proposed loan, with such assessment based on a capital and interest basis (self-amortizing basis) on a maximum term of twenty-five years, and test the affordability assessment against interest rate increases.[235]

The Board's 2008 amendments to its Truth in Lending regulations, effective October 1, 2009, significantly broadened the reach of regulatory prohibitions. It established a category of loans called "higher-priced mortgage loans" in order to subject such loans to additional prohibitions and other consumer protections.[236] The Board's definition of "higher-priced mortgage loans" includes all subprime mortgages. The new regulations prohibit loans made without regard to the borrower's ability to repay and restrict prepayment penalties.[237] This is a return to a more rules-based regulatory regime, similar to the regime that was in place for insured depository institutions prior to

234. *See infra* notes 236–40 and accompanying text.
235. Fin. Serv. Auth., Mortgage Market Review: Responsible Lending 10/16, at 8–9 (2010), *available at* www.fsa.gov.uk/pubs/cp/cp10_16.pdf; *see also* Fin. Serv. Auth., Mortgage Market Review 09/3, at 36–59 (2009).
236. Truth in Lending, 73 Fed. Reg. 44,522 (July 30, 2008).
237. *Id.* at 44,539. Under the new regulations: (a) lenders are prohibited from making a loan without regard to borrowers' ability to repay the loan from income and assets other than the home's value, and a lender must assess repayment ability based on the highest scheduled payment in the first seven years of the loan; (b) creditors must verify the income and assets they rely upon to determine repayment ability; (c) any prepayment penalty is banned if the payment can change in the initial four years, and for other higher-priced loans, a prepayment penalty period cannot last for more than two years; and (d) creditors must establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans. *Id.* at 44,539, 44,543, 44,551.

1982.[238] The Act imposes such a regime on all residential mortgage loans,[239] and on all creditors that regularly extend credit, not just insured depository institutions.[240]

The unsafe mortgage products and practices that became prevalent in the last ten years include the following: no documentation or limited documentation loans, loans leading to significant payment shocks in the form of payment option loans and ARMs with low initial interest rates, and loans with little or no borrower equity primarily due to piggyback loans.[241] The unfair mortgage products and practices that increasingly surfaced in the market were loans charging excessive interest rates and fees; loans with excessive prepayment penalties and penalties that make refinancing difficult; and forced refinancing and loan flipping.[242]

The Act imposes mandatory and more detailed requirements and prohibitions than were in place in the period from 1982 to 2009. Most of these rules are aimed at avoiding the unsafe mortgage products witnessed from 2002 to 2007. By contrast, unfair mortgage products are still primarily addressed through a principles-based regime. Legal scholarship notes that no legal regime is entirely principles-based or rules-based, and even regimes that are primarily one or the other contain degrees of precision and imprecision.[243] The new rules prescribed for unsafe mortgage products contain areas of imprecision that could lead to creative compliance—evasion—by industry members motivated by short-term profits.

The Act's new prescriptive rules impose minimum underwriting standards that prohibit no documentation and limited documentation

238. For example, prior to its amendment in 1982, 12 U.S.C. § 371, governing the real estate lending powers of national banks, required a maximum loan to value ratio of 90% when the collateral was improved real estate and required any loan secured by a one- to four-family residence with a loan to value ratio in excess of 75% to contain installment payments sufficient to amortize the entire principle of the loan within a period of not more than thirty years.

239. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1411(a)(2), 124 Stat. 1376, 2142–45 (2010) (amending 15 U.S.C. § 1639c).

240. The Act's minimum underwriting standards apply to any "creditor." *Id.* The legislative amendments are part of the Truth in Lending Act, which defines "creditor" as a person who regularly extends consumer credit. *See* 15 U.S.C. § 1602(f) (2006).

241. *See supra* Part I.C.

242. *See supra* Part I.C.3.

243. *See* Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting*, 60 VAND. L. REV. 1409, 1431–33, 1449–51, 1492 (2007); Schauer, *supra* note 7, at 804–06; *cf.* Sunstein, *supra* note 7, at 959–68 (discussing legal requirements imposed in case law).

loans by requiring verification of income and assets;[244] minimize the likely adverse effects of payment shocks due to ARMs, payment option loans, and piggyback loans by requiring that the borrower has a reasonable ability to repay the loan (though these loans are not prohibited);[245] limit prepayment penalties;[246] and seek to reduce excessive interest rates and fees by prohibiting compensation to brokers that varies based on the terms of the loans brokered.[247]

An example of the change in regulatory approach is provided by the changes addressing the issue of no documentation or limited documentation loans and payment shocks. The Act replaces reliance upon general principles with a specific statutory mandate. It requires creditors to make a reasonable and good faith determination, based on verified and documented information, that a prospective borrower has "a reasonable ability to repay" the desired loan.[248] That mandate is also imposed whenever there are multiple loans secured by the same dwelling.[249] This directive requires additional regulatory clarification. There is a degree of imprecision in the current requirements because "ability to repay" standard is not defined, meaning there is no maximum debt-to-income ratio. There is also no maximum loan-to-value ratio stipulated in the statute. The Act does indicate, however, that in determining a borrower's ability to repay the loan, a creditor shall consider certain factors, including the consumer's credit history, current income, expected income, current debt obligations, the ratio of income to debt, employment status, and other financial resources.[250] These factors are nonexclusive and are merely to be considered. No criteria, including the borrower's income, are required in order to

244. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1411, 124 Stat. 1376, 2142–45 (2010) (amending 15 U.S.C. § 1639c).

245. *Id.*

246. § 1414(a), 124 Stat. at 2149–50 (amending 15 U.S.C. § 1638).

247. § 1403, 124 Stat. at 2139–41 (2010) (amending 15 U.S.C. § 1639b). The statue may effectively limit total points and fees to 3% of the total loan amount by including this requirement for classification as a "qualified mortgage[ ]," which presumptively satisfy the minimum underwriting standards imposed in the Act. *See* § 1412, 124 Stat. at 2138–39 (establishing the safe harbor and rebuttable presumption); § 1411 (establishing minimum standards for ability to repay).

248. § 1411(a)(2), 124 Stat. at 2142–45 (adding a new section, § 129C(a), to the Truth in Lending Act).

249. *Id.* The Act also mandates that ability to repay for nonstandard loans, such as variable rate loans and interest-only loans, must be based on a payment that fully amortizes the loan at the fully indexed rate. *Id.* A creditor may establish a presumption of compliance, however, if, inter alia, the maximum rate permitted under the terms of an adjustable rate loan during the first five years is the basis for determination of borrower's ability to repay. § 1412, 124 Stat. at 2145–48.

250. § 1411(a)(2), 124 Stat. at 2142–45 (listing the minimum standards for residential mortgage loans in the Truth in Lending Act).

make an ability to repay determination.[251] Future regulations from the Consumer Financial Protection Bureau (Bureau) may eliminate or minimize these areas of imprecision.[252]

The Act also clarifies how the "ability to repay" standard is to be applied to non-standard loans, meaning loans that are not fixed rate, self-amortizing loans.[253] For variable rate mortgages that allow a consumer to defer any repayment of principal or interest, the creditor must use a fully amortizing repayment schedule to determine a consumer's ability to repay.[254] For interest-only loans, the creditor must use the payment required to amortize the loan by its final maturity to determine consumer's ability to repay.[255] For all calculations, the creditor must assume that the loan proceeds are fully disbursed, the loan is repaid in equal monthly amortizing payments for principal and interest over the entire term of the loan, and the interest rate over the entire term is a fixed rate equal to the "fully indexed rate" at the time of the loan closing.[256] In addition, if the creditor knows or has reason to know that one or more residential mortgage loans secured by the same dwelling will be made to the same consumer, then the "ability to repay" determination must be based on the combined payments for all loans.[257] This adds an impression of greater precision to the regulatory requirements; it does not, however, change the underlying weaknesses in the ability to repay standard, as discussed earlier.

Another example of the change in regulatory approach from principles-based regulation to prescriptive rules is found in the Act's mandate regarding prepayment penalties. Prior to 2009, creditors, including insured depository institutions and their affiliates, were faced with the statutory and regulatory mandate to avoid terms that were "unfair."[258] The Act instead provides that a "residential mortgage loan that is not a 'qualified mortgage,' as defined under subsection (b)(2), may not contain terms under which a consumer must pay a

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251. *Id.* (indicating that the determination of a borrower's ability to repay and income verification be based on non-exhaustive lists of representative documents).

252. For example, the Act refers to the possible regulatory imposition of debt-to-income requirements. § 1412 (defining the term "qualified mortgages" include guidelines or regulations relating to debt to income ratios); *see also* § 941(b), 124 Stat. at 1890–96 (outlining possible requirements to be imposed on "qualified residential mortgages").

253. § 1411(a)(2), 124 Stat. at 2142–45 (clarifying amendments to the Truth in Lending Act).

254. *Id.* (stating the standard to be applied in the amended Truth in Lending Act).

255. *Id.*

256. *Id.*

257. *Id.*

258. *See supra* Part I.B.

prepayment penalty for paying all or part of the principal after the loan is consummated."[259] In addition, for qualified mortgages,[260] the Act limits prepayment penalties to 3% of the outstanding balance of the loan in year one, 2% in year two, and 1% in year three, and prohibits prepayment penalties after the first three years of the loan.[261] Finally, a creditor offering a mortgage loan with a prepayment penalty must also offer the borrower a mortgage loan without a prepayment penalty.[262]

The limitations on prepayment penalties are one of two new directives aimed at unfair, in contrast to unsafe, mortgage practices. The other is aimed at excessive interest rates and fees. The Act does not comprehensively address this area of concern. Instead, it targets only the practices of mortgage brokers. The Act prohibits payment to and receipt by a mortgage broker of compensation that varies based on the terms of the loan (other than the amount of the principal).[263]

The Act continues to rely upon principles-based regulations to address most of the unfair mortgage products and practices encountered in the last decade. It enacts new principles-based standards in the form of a prohibition against "unfair, deceptive, or abusive" acts or practices in connection with any consumer financial product or service.[264]

Greater precision might be provided in future regulations promulgated by the Bureau, or in the standards promulgated by federal regulators when defining the term "qualified residential mortgages" for purposes of the risk retention requirements contained in Title 9 of the Act.[265] However, if it is Elizabeth Warren's view that principles-based regulation should be the approach favored under the Act, this standard will not be provided a great deal of regulatory precision.

The question remains whether the shift toward more rules-based regulation will lead to greater congruence with legislative purposes.

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259. § 1414(a), 124 Stat. at 2142–45 (adding section 129C(c)(1)(A) to the Truth in Lending Act).

260. § 1412, 124 Stat. at 2145–48 (adding section 129C(b) to the Truth in Lending Act, defining the term "qualified mortgages" and recognizing a rebuttable presumption of compliance with the Act's ability to repay requirements for qualified mortgages).

261. § 1414(a), 124 Stat. 1376, 2142–45 (adding section 129C(c)(3) to the Truth in Lending Act).

262. *Id.*

263. § 1403, 124 Stat. at 2139–41.

264. § 1031(a), 124 Stat. at 2005–06.

265. *See* § 941(b), 124 Stat. at 1890–96 (indicating that the federal banking agencies, SEC, Secretary of Housing and Urban Development and director of the Federal Housing Finance Agency are to jointly define the term qualified residential mortgage).

Research into industry compliance with regulatory standards demonstrates that certainty in statutory or regulatory mandates increases the likelihood of compliance.[266] However, an equally important—perhaps *more* important—factor inducing industry compliance is altering the cost-benefit evaluations that are the basis of industry decisions, even decisions to comply with or evade legal mandates. Part of that industry evaluation is an evaluation of the likelihood of enforcement and severity of enforcement measures.

B. The Key to Legislative Congruence

1. Studies of Corporate Legal Compliance

The frequency and severity of sanctions imposed for non-compliance[267] and the nature of the legal directive[268] are among the variables that strongly influence corporate compliance with legal mandates. As to the nature of the legal mandate, a legal regime with clear standards that stipulate required action or course of conduct (rules-based regime) is the approach that generates greater corporate commitment to legal compliance.[269] By contrast, a general standard (principles-based regime) is the least effective in inducing corporate commitment to legal

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266. *See infra* Part III.B.1.

267. *See* Di Lorenzo, *Does the Law Encourage Unethical Conduct in the Securities Industry?*, 11 FORDHAM J. CORP. & FIN. L. 765, 782–803 [hereinafter Di Lorenzo, *Securities Industry*] (comparing cost-benefit evaluations of legal sanctions in the securities industry to cost-benefit evaluations in the banking industry and discussing the banking industry's compliance with the Community Reinvestment Act); Wayne B. Gray & John T. Scholz, *Does Regulatory Enforcement Work? A Panel Analysis of OSHA Enforcement*, 27 LAW & SOC'Y REV. 177 (1993) (studying the impact of OSHA enforcement on workplace injuries and concluding that increased enforcement actions can affect corporate behavior in ways that advance regulatory goals); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution*, 23 LAW & SOC'Y REV. 209 (1989) (studying taxpayer behavior and arguing that taxpayers are less willing to engage in noncompliance if they believe noncompliance will lead to detection and punishment); Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards,* 17 ACCT. HORIZONS 91, 99–100 (2003) (studying financial reporting by corporations). *But see* John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 LAW & SOC'Y REV. 7, 35 (1991) (studying Australian nursing homes and arguing that certainty of enforcement had few deterrent effects on examined businesses).

268. *See* Vincent Di Lorenzo, *Business Ethics: Law as a Determinant of Business Conduct*, 71 J. BUS. ETHICS 275 (2006) [hereinafter Di Lorenzo, *Business Ethics*] (studying the securities, automobile, pharmaceutical, and mortgage banking industries and arguing that clear legal mandates are more likely to positively influence corporate compliance than vague standards); Di Lorenzo, *Securities Industry*, *supra* note 267, at 770–71.

269. Di Lorenzo, *Business Ethics*, *supra* note 268 (arguing that rules-based regimes lead to more substantial corporate compliance than principles-based regimes).

compliance.[270] In both cases, a very important influence on corporate compliance is the frequency and severity of the sanctions imposed for noncompliance.[271] Prior research places this factor in context, demonstrating that industry actions are based on cost-benefit evaluations of the benefits and risks of compliance, noncompliance, or evasion.[272] Enforcement measures—the available sanctions and the choice of sanctions imposed—are an important factor in industry cost-benefit evaluations.[273]

The viewpoint presented in public policy literature is that uncertainty generated by a principles-based regime leads corporate actors to be more conservative in their activities, and therefore more likely to take actions congruent with legislative purposes.[274] This view assumes there is reason to be conservative—that the regulatory agencies rigorously enforce legislative mandates and the costs of noncompliance are sufficiently great to influence corporate actions.

The mortgage market experience over the last decade confirms the results of this earlier research. A principles-based regulatory regime in the mortgage market coupled with few enforcement measures led industry members to ignore the legal mandates prohibiting both unsafe and unfair mortgage products and practices. A regime that shifted into a slightly more rule-based regime for unsafe mortgage products after 2001, through issuance of real estate lending guidelines applicable to depository institutions, still led some depository institutions, including leading participants in the mortgage markets, to ignore the guidelines (the rules).[275] This was an environment in which sanctions were typically not enforced, and, if and when sanctions might be imposed, the nature of the expected sanction resulted in little cost to

270. *Id.*

271. *See* Black et al., *supra* note 7, at 195, 198; Di Lorenzo, *Business Ethics*, *supra* note 268; Di Lorenzo, *Securities Industry*, *supra* note 267, at 801 (noting that certain market-based sanctions contained in the Community Reinvestment Act had an effect on corporate compliance); Ehrlich & Posner, *supra* note 7, at 262; Gray & Scholz, *supra* note 267, at 199 (finding a relationship between penalty-based sanctions and corporate compliance with OSHA); Edward J. Kane, *Ethical Failures in Regulating and Supervising the Pursuit of Safety-Net Subsidies*, 10 Euro. Bus. Org. L. Rev. 185, 187 (2009).

272. Di Lorenzo, *Securities Industry*, *supra* note 267, at 782–85.

273. *Id.*

274. *See* Black et al., *supra* note 7, at 195; Kennedy, *supra* note 7, at 1695–96; Korobkin, *supra* note 10, at 46, 56–57 (presenting the argument but then noting its shortcomings); Schwarcz *supra* note 10 (arguing that the uncertainty created by a principles-based regime will cause some actors, particularly large corporations, to behave more conservatively in order to avoid liability).

275. *See* discussion *supra* Part I.C.1.

the violator.[276] Noncompliance was viewed as a reasonable business decision for industry members. Industry cost-benefit evaluations in the mortgage market in the period from 2002 to 2008 are explored below.

2. *Industry Cost-Benefit Evaluations: A Study of the Mortgage Market, 2002–2008*

a. *Substantial Profits from Unsafe and Unfair Loans*

Whether market discipline or regulatory sanctions lead mortgage lenders to avoid originating unsafe and unfair loans depends upon the originator's evaluation of the benefits and risks of unsafe and unfair mortgage practices.

Unfair mortgage practices in the form of excessive interest charges, fees and prepayment penalties, as well as unfair refinancing and loan flipping, are rather easily evaluated. All of these practices generate significant profits for the originators.[277] For example, Countrywide discouraged its sales force from offering fixed rate Federal Housing Administration (FHA) loans to borrowers, which may be suited for low-income or first-time homeowners.[278] One Countrywide salesman noted that a recent applicant for a $275,000 loan could have been offered an FHA loan with a 7% fixed interest rate and 0.125 percentage points.[279] Instead, the borrower was granted a subprime loan with an interest rate of 9.875% and three additional points.[280] The monthly payment would have been $1,829 on the FHA loan, while Countrywide's subprime loan led to a monthly payment of $2,387—a difference of $558 a month or $6,698 per year.[281] This additional monthly payment is a burden placed on a low-income homeowner but is additional profit generated for the originator or investor, who also received the additional $7,906 profit generated by the higher points charged at origination.[282]

In addition to extra profits from higher interest rates and fees, prepayment penalties generated $268 million in revenue for Country-

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276. *See infra* notes 306–31 and accompanying text.

277. *See supra* Part I.C.3-b (noting the costs to consumers that are also profits for the originator or broker).

278. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, at B1.

279. *Id.*

280. *Id.*

281. *Id.*

282. A loan of $275,000 carrying additional loan origination fees, in the form of points, of 3% would obligate the borrower to pay to the lender an additional $8,250 in loan origination fees.

wide in 2006 and $212 million in 2005.[283] If the loans were sold, investors paid more for loans with higher interest rates and prepayment penalties.[284] Thus the profits from excessive interest rates, fees, and prepayment penalties accrue to the originator either as holder of the loans or as recipient of funds from secondary market investors upon sale of the loans as part of a mortgage pool. Unfair refinancing and loan flipping, by definition, multiplies the incidence of imposition of excessive charges and prepayment penalties, to the benefit of the originator.

Additional comment is necessary on the practice of relying on mortgage brokers to generate loan volume. The market provided incentives to such brokers to generate unfair loan products. Brokers received higher compensation for loans generated with higher interest rates and prepayment penalties, as well as payment option ARMs.[285] For example, according to the March 2007 "rate sheet" distributed by New Century Financial, brokers could earn a yield spread premium of 2% of the loan amount if a borrower's interest rate was an extra 1.25 percentage points higher than the lender's listed rates.[286] This practice compensated brokers for convincing borrowers to accept a loan at an interest rate higher than that for which they would qualify at most lending institutions. In fact, industry-wide mortgage brokers collected an average 1.88% of the loan amount for originating a subprime loan, which carried higher interest rates, compared with 1.48% for originating a conforming loan.[287]

Brokers also received higher compensation by imposing prepayment penalties. At Countrywide, for example, brokers would receive an extra 1% of a loan's value by adding a three-year prepayment penalty to the mortgage loan.[288] All of these compensation formulas were the result of the higher profits that the unfair loan products in question would generate for the loan originators and/or investors.

This analysis of compensation incentives focused on unfair mortgage products, namely loans that unfairly burdened borrowers with excessive interest, fees, and prepayment penalties, as well as refinanc-

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283. Morgenson, *Inside Countrywide Lending Spree*, *supra* note 278.

284. Complaint, *supra* note 107, at 38 (stating that investors paid more for loans with prepayment penalties, and brokers made more money from loans with prepayment penalties).

285. Offices of Inspector Gen., *supra* note 138, at 9 (noting that payment-option ARMs accounted for as much as half of WaMu's total loan origination fees from 2003 to 2007).

286. Brooks & Simon, *supra* note 199.

287. *Id.*

288. Morgenson, *Inside Countrywide Lending Spree*, *supra* note 278.

ing and loan flipping. Turning to unsafe mortgage practices, the mortgage market evolved to create significant benefits for originators of unsafe mortgage products that overshadowed possible risks. As a result, originating unsafe mortgage loans was deemed to be a reasonable business practice based on industry cost-benefit evaluations. This is the same conclusion reached in previous scholarship examining the business practices of the securities industry.[289]

The innovative mortgage products, discussed earlier, that led to substantial numbers of foreclosures in recent years were ARMs, especially ARMs in which the borrower's ability to repay was based on an initial, low interest rate, payment option loans, and similar loans that led to negative amortization and a later recast of payments, no documentation and limited documentation loans, and piggyback loans.[290] The business practices that emerged in recent years caused these loans to be very profitable for originators. For example, the compensation scheme system for brokers acting on behalf of Countrywide was based on a yield spread premium. The amount of the yield spread premium was greatest for brokers using payment option ARMs because the low initial interest rate on ARMs hid from borrowers' scrutiny the actual interest rate to be charged after reset, including the amount of the margin to be added to the index for calculating the adjusted interest rate.[291] In addition, the minimum payment option hid the eventual true monthly payment required of the borrower.[292] Brokers maximized compensation not only by convincing the borrower to accept a payment option ARM but also to accept one with a slightly higher, initial teaser rate, the maximum margin permitted by Countrywide's product offerings, and a prepayment penalty.[293] Nationwide broker commissions were, on average, up to 2.5% for payment option ARMs compared with 1.88% for subprime loans, and 1.48% for standard fixed rate mortgages.[294]

Payment option ARMs were profitable for originators and holders of such mortgage loans, which is the reason for the higher compensation structure for brokers initiating such loans. It is estimated that as much as $389 billion in payment option ARMs were originated in 2004 and 2005, and some $182 billion were sold to investors through mortgage-backed securities in each of these years.[295] Investors paid

289. Di Lorenzo, *Securities Industry*, *supra* note 267, at 782–94.
290. *See supra* Part I.C.1.
291. *Id.*
292. *Id.*
293. Complaint, *supra* note 107 at 45–47.
294. Simon & Hagerty, *supra* note 107.
295. Mara Der Hovanesian, *Nightmare Mortgages*, Bus. Wk., Sept. 11, 2006, at 70.

higher prices for such loans that would reset at high interest rates and often contained prepayment penalties. Moreover, the payment option ARMs that remained in the lenders' portfolios generated substantial phantom profits. This is because under generally accepted accounting principles banks can report as revenue the highest amount of an option ARM payment, meaning the fully amortized amount, even when the borrowers make a minimum payment.[296] Thus, the banks claimed future revenue immediately, inflating their earnings per share. Such phantom profits accounted for 67% of second-quarter pretax profit at First Fed Financial in 2006, and 59.6% of the Golden West Financial's earnings in the first half of 2006.[297] At Countrywide, such income totaled $654 million in 2006, and $1.2 billion in 2007.[298] As a result, originators promoted payment option loans.[299]

Overall, the many higher sources of compensation for originators of subprime mortgage loans, including higher prices paid by investors for the higher interest rates on such loans, and ARMs that would reset at higher levels and mortgages with prepayment penalties, generated higher profit margins.[300]

In addition to higher profits generated by ARMs and by payment option loans, as well as subprime loans generally, the piggyback loan structure was also profitable for originators and investors because a higher interest rate was applied to loans in the second lien position. This resulted in a higher income stream for holders of such loans or investors.[301]

Finally, the no-documentation or low-documentation loan was also favored by originators as a source of profit. This may seem counterintuitive because of the potential risk of default, but the demand for loans to be sold to the secondary market was very strong in the middle years of this decade.[302] Low-documentation or no-documentation in that context became profitable for originators because

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296. *Id.* This is based on so-called accrual accounting.

297. *Id.*

298. Complaint, *supra* note 107, at 44.

299. John W. Schoen, *'Pay Option' Loans Could Swell Foreclosures*, MSNBC, Dec. 10, 2008, http://www.msnbc.msn.com/id/28035238 (noting that Wachovia required nearly half of consultants' originated loans to be payment option loans and documenting the higher commissions paid for such loans).

300. Morgenson, *Inside Countrywide Lending Spree*, *supra* note 278 (showing that Countrywide had substantially higher profit margins on subprime mortgages, as compared with prime mortgages, in 2004, 2005 and 2006).

301. Complaint, *supra* note 107, at 53.

302. *See* INQUIRY REPORT, *supra* note 102, at 102 (finding that investors hungered for higher-yield mortgages such as subprime loans, nontraditional loans and limited or no documentation loans).

borrowers were charged higher fees for such loans in the origination process, and such loans could be approved more quickly—thereby generating greater loan volume.[303]

b. Insubstantial Risks: Actual or Perceived

Theoretically, the market discipline relied upon to constrain unfair and unsafe practices would be due to the risk of loss suffered by the industry from such practices, both market losses and losses from imposition of legal sanctions, and the ethical duty to comply with legal directives. Too often predictions regarding the effects of market discipline are based upon theoretical decisions that will be reached by rational decision makers evaluating risks and benefits in a static environment. This article does not embrace such an evaluative approach, but examines actual outcomes to ascertain how one initial change interacts with all other influences in the business environment to produce an outcome.[304] As documented above, the actual outcome in the U.S. mortgage market was an increased offering of both unfair and unsafe mortgage products in recent years.[305]

Risk of loss in the form of legal sanctions is one type of loss that may influence corporate behavior. There is no specific federal prohibition against unfair mortgage practices in the form of excessive interest rates, fees, and prepayment penalties, as well as unfair refinancing and loan flipping. The only federal prohibition is the general duty to avoid unfair practices contained in the FTC Act.[306] None of the unfair practices enumerated in this article were specifically defined as unfair mortgage practices in any regulations issued under the FTC Act, and therefore none were prohibited for all originators.[307] Federal bank regulatory agencies can bring individual enforcement actions against particular practices of individual banks.[308] However, they did not do so with respect to the unfair mortgage practices that are the subject of this article.[309] The actions brought were based on misrepresentations

303. Complaint, *supra* note 107, at 28.

304. *See* Di Lorenzo, *Securities Industry*, *supra* note 267, at 769–70 (finding that corporate decision making is a product of the interaction of various factors, including cost projections, risk projections, legal mandates, and industry norms, requiring analysis of actual market outcomes).

305. *See supra* Parts I.C.1, I.C.3.

306. 15 U.S.C. § 45(a) (2006).

307. *See supra* Part I.C.3.

308. 12 U.S.C. § 1818(c) (2006).

309. In January 2004, the General Accounting Office (now named the Government Accountability Office (GAO)) reported that OTS, FDIC, the Federal Reserve, and the National Credit Union Administration had taken no formal enforcement actions related to predatory mortgage lending against the institutions they regulate. Officials at

of the terms of loans (deceptive practices) or violations of explicit statutory HOEPA prohibitions.[310] This was the conclusion of the General Accounting Office's review of the enforcement activities of the federal agencies with regard to predatory lending practices as of January 2004—a date on which unfair mortgage practices had existed for some time and unsafe mortgage practices were about to be offered with greater and greater frequency. Subsequent analysis of enforcement actions on the part of federal bank regulators uncovered additional actions in 2005 and 2006 but relatively few actions.[311] This conclusion holds true with respect to the FTC, as well, which has jurisdiction to bring actions against independent mortgage companies and mortgage affiliates of banks and thrifts.[312]

With respect to unsafe mortgage practices, the federal prohibition for banks and thrifts is the general federal prohibition against "unsafe and unsound" banking practices,[313] as well as the guidance on subprime and nontraditional loan products.[314] Enforcement actions are rarely brought for originating or purchasing loans without regard to ability to repay.[315] In addition, if and when such actions are taken, typically the only sanction would be an agreement or order against an

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OCC said they had taken one enforcement action. U.S. GEN. ACCOUNTING OFFICE, GAO-04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 43 (2004) [hereinafter CONSUMER PROTECTION]. That action, taken in 2003, was against Clear Lake National Bank, later to become Lone Star Capital Bank, and involved violation of the disclosure requirements contained in HOEPA, the Truth in Lending Act, the Real Estate Settlement Procedures Act and "unfair practices inherent in the tax lien loans." Office of the Comptroller of the Currency Consent Order, *In re Clear Lake Nat'l Bank, San Antonio, Texas*, at 2, No. 2003-135 (Nov. 7, 2003), http://www.occ.gov/static/enforcement-actions/ea2003-135.pdf.

310. CONSUMER PROTECTION, *supra* note 309, at 37–38.

311. Greg Ip & Damian Paletta, *Lending Oversight: Regulators Scrutinized in Mortgage Meltdown; States, Federal Agencies Clashed on Subprimes As Market Ballooned*, WALL ST. J., Mar. 22, 2007, at A1.

312. Prepared Statement Before the U.S. Comm'n on Civil Rights, Fed. Trade Comm'n, Civil Rights Issues Emerging from the Mortgage Crisis 3–6 (Mar. 20, 2009) [hereinafter Civil Rights Issues]. The FTC has brought 26 actions, including 8 since January 2004, alleging deceptive or unfair practices against companies in the mortgage lending industry, but the actions largely involve deceptive or illegal marketing. *Id.* The FTC enforces the FTC Act against non-bank financial companies, mortgage brokers, and subsidiaries of bank holding companies. The bank regulatory agencies enforce the FTC Act against banks, thrifts, federal credit unions and their subsidiaries. However, the Federal Reserve and Office of Thrift Supervision also have jurisdiction over bank holding company subsidiaries with respect to "safety and soundness" issues.

313. 12 U.S.C. §§ 1463, 1818, 1828(o), 1831p-1(c)(1) (2006).

314. EXPANDED GUIDANCE, *supra* note 66; HIGH LTV REAL ESTATE LENDING, *supra* note 64; INTERAGENCY GUIDANCE ON SUBPRIME LENDING, *supra* note 63.

315. *See supra* notes 120–25, 135, 140–41, and 149–50.

individual bank to stop such practices.[316] The result was virtually no risk of legal sanction, and when such action might be taken the risk was merely the risk of facing a cease and desist order. Cost-benefit analysis therefore led to the conclusion that originating unsafe loans was a reasonable business decision.

An example of the low risk of legal sanctions due to unsafe mortgage loans is provided by analysis of regulatory enforcement actions against leading bank originators of such loans. As documented earlier in the article, Countrywide, WaMu, Wachovia and IndyMac, among others, originated substantial numbers of payment option ARMs and no documentation loans.[317] A search of the online files of reported enforcement actions from 2002 through 2008 revealed no enforcement actions against any of the four institutions related to their mortgage underwriting activities.[318] The agencies' records of enforcement ac-

316. Todd Davenport, *OCC's New Predator Rule; Are Violations a Safety-and-Soundness Issue?*, AM. BANKER, Feb. 3, 2005, at 1 (The OCC defines anti-predatory lending standards as a safety and soundness issue, and enforces these violations, first, through either a deficiency letter or in an examination report. If a bank does not properly respond, the OCC follows up with a safety-and-soundness order, the equivalent of a cease and desist order. Lastly, failure to comply with the order can result in possible civil monetary penalties.). *See also Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 4–7 (2009) [hereinafter Statement of John C. Dugan] (statement of John C. Dugan, Comptroller of the Currency) (stating that most bank problems are resolved through the supervisory process, without resort to an enforcement action, and enforcement actions whether informal or formal typically involve an agreement or order to cease the unsafe or unsound practice with relatively few civil money penalties being imposed against the banks); Ip & Paletta, *supra* note 311 (reporting that actions taken by the federal banking agencies in the last two years have been in the form of cease and desist orders). For a description of the types of enforcement actions utilized by the federal banking agencies, see Jackie Brunmeier & Niel Willardson, *Supervisory Enforcement Actions Since FIRREA and FDICIA*, THE REGION, Sept. 2006, at 26. Civil money penalties are available in addition to formal and informal supervisory actions and cease and desist orders, but are rarely imposed for consumer violations generally, let alone for unfair mortgage practices specifically. A single action related to violation of consumer protection statutes accounts for the entire number of assessments in the form of civil money penalties attributed to consumer protection weaknesses in the period 1999–2005. *Id.*

317. *See supra* Part I.C.3.

318. The search was of the enforcement actions from 2002 through, and including, 2008 in the online files of the FDIC. FED. DEPOSIT INS. CORP., *FDIC: Enforcement Decisions and Orders*, www.fdic.gov/bank/individual/enforcement/ (last visited Oct. 25, 2011); BD. OF GOVERNORS OF THE FED. RESERVE SYS., *FRB: Enforcement Actions*, www.federalreserve.gov/apps/enforcementactions/search.aspx (last visited Oct. 25, 2011); OFFICE OF THE COMPTROLLER OF THE CURRENCY, *OCC: Enforcement Actions*, apps.occ.gov/EnforcementActions/ (last visited Oct. 25, 2011); OFFICE OF THRIFT SUPERVISION, *Office of Thrift Supervision Enforcement Search*, www.ots.gov/?p=EnforcementSearch (last visited Oct. 25, 2011). That search uncovered only three enforcement actions, by the OCC against Wachovia in 2008 and they involved allega-

tions encompass formal enforcement actions, such as cease and desist orders and civil monetary penalties.[319] They do not encompass informal agreements after examinations.[320] The recent reports of the Office of Inspector General of the FDIC, however, shed light on the agencies' actions. The Report of Regulatory Oversight of Washington Mutual Bank, for example, discusses the large number of high-risk payment option ARMs and no documentation loans originated by WaMu and then indicates that neither the OTS nor the FDIC took any action until February 2008.[321] By that time, a memorandum of understanding to correct weaknesses in underwriting practices was proposed, and was signed shortly thereafter on March 17, 2008.[322] Later, concerns were raised that WaMu had not corrected the weaknesses.[323] A subsequent memorandum of understanding was then negotiated with management.[324] It was not signed until September 7, 2008, one week before the bank went into receivership.[325] Similarly, the Office of Inspector General's Report on IndyMac found high-risk underwriting practices, including no documentation or low documentation loans.[326] No memorandum of understanding to correct these underwriting practices was entered into until June 20, 2008.[327] On July 11, 2008 the OTS closed the bank.[328]

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tions that Wachovia allowed telemarketers to use its accounts to steal funds from unsuspecting victims. Office of the Comptroller of the Currency, Amended Agreement by and between Wachovia Bank, National Assoc., Charlotte, North Carolina and the Office of the Comptroller of the Currency, No. 2008-159 (Dec. 4, 2008), http://www.occ.gov/static/enforcement-actions/ea2008-159.pdf [hereinafter AMENDED AGREEMENT] ; Office of the Comptroller of the Currency, Agreement by and between Wachovia Bank, National Assoc., Charlotte, North Carolina and the Office of the Comptroller of the Currency, No. 2008-028 (Apr. 24, 2008), http://www.occ.gov/static/enforcement-actions/ea2008-028.pdf (amended by AMENDED AGREEMENT); Office of the Comptroller of the Currency, Consent Order, *In re Wachovia Bank, National Assoc., Charlotte, North Carolina*, No. 2008-027 (Apr. 24, 2008), http://www.occ.gov/static/enforcement-actions/ea2008-027.pdf.

319. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *Enforcement Actions*, www.federalreserve.gov/apps/enforcementactions; FDIC, *Enforcement Decisions and Orders*, www.fdic.gov/bank/individual/enforcement/ (last visited Nov. 17, 2011).

320. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, PPM 5310-3 (REV), POLICIES & PROCEDURES MANUAL (2011); OFFICE OF THRIFT SUPERVISION, EXAMINATION HANDBOOK § 080 (2008) (comparing informal and formal enforcement actions).

321. OVERSIGHT OF WASHINGTON MUTUAL, *supra* note 137, at 9–11, 31.

322. *Id.*

323. *Id.*

324. *Id.*

325. *Id.* at 32–33.

326. OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REPORT NO. EVAL-09-006, THE FDIC'S ROLE IN THE MONITORING OF INDYMAC BANK (2009) [hereinafter MONITORING OF INDYMAC].

327. *Id.* at 28.

328. *Id.* at 29.

State laws may also impose constraints or sanctions for originating unsafe loans and possibly, unfair loans for state chartered institutions, including mortgage companies. Examination of the limited coverage and limited enforcement actions taken by state authorities is beyond the scope of this article. However, others scholars address these topics and documented the lax state enforcement measures which all contribute to originators' view that the risk of enforcement action on the part of state regulators as either nonexistent or small.[329]

A Senate Report examining the factors leading to the financial crisis noted that it resulted from the spectacular failure of the prudential regulators to protect average American homeowners from risky, unaffordable mortgages.[330] The report stated that regulators, "routinely sacrificed consumer protection for short-term profitability of banks."[331]

Setting aside legal sanctions, we are left with actual or expected market losses serving to discipline mortgage practices that may lead to default and foreclosure. This is because, in the event of foreclosure, the lender or holder of the loan is likely to suffer a substantial loss.[332] However, originators and investors convinced themselves that long-term default was unlikely. As a result, the General Accounting Office found investors had concluded that, "loans with predatory features may carry very high interest rates and have barriers to prepayment, which may more than compensate for the increased credit risks associated with subprime loans."[333] That conclusion is consistent with earlier research into the actions of the securities industry and the skewed risk perception of corporate actors.[334] Namely, there is an inverse relationship in individuals' perceptions of risks versus benefits. When a substantial benefit is perceived (i.e. high profits produced by a course of action), then any risk posed by the activity is viewed as a low risk. Legal sanctions were in fact a low risk. Market losses were potentially a greater risk, but were perceived to be a low risk—a perception brought about by the rising value of real estate prices in recent

329. *E.g.*, Ip & Paletta, *supra* note 311. Many state regulators lack the resources and mandates of their federal counterparts. For example, the California Department of Corporations has twenty-five examiners to oversee more than 4,800 state licensed lenders, including many of the country's largest subprime companies. *Id.*

330. S. Rep. No. 111-176 (2010) (Conf. Rep.).

331. *Id.* at 15 (citation omitted).

332. David Wessel, *Why Some Mortgage Bailouts Make Sense*, Wall St. J., Nov. 15, 2007, at A2 (reporting that foreclosure costs a lender as much as 40% or 50% of the unpaid balance).

333. Consumer Protection, *supra* note 309, at 76.

334. Di Lorenzo, *Securities Industry*, *supra* note 267, at 788.

years;[335] refinancing of potentially unsafe loans allowed due to rising real estate values, which avoided losses in the short-term;[336] the alleged diversification of risk produced by bundling loans into mortgage backed securities;[337] and the favorable credit ratings granted to such securities by credit agencies.[338]

Failure of market discipline due to skewed risk perception led to risky loan practices in the 1980s that were very similar to recent risky loan practices. The difference is that in the 1980s, such practices occurred with respect to mortgage loans secured by commercial real estate. The incidents documented in the 1980s on the part of the banking industry include the following:

- savings and loan associations in need of immediate profits had an incentive for risk taking with respect to construction loans because they could charge high upfront loan fees and earn high interest rates by paying themselves through adding sums to the principal;[339]
- loans were made at 100% of appraised value;[340] incentives were created to lend up to 100% of loan to value because developers

335. Jack Guttentag, *Shortsighted About the Subprime Disaster*, WASH. POST, May 26, 2007, at F2 (commenting on the assumption that housing prices would continue to rise).

336. Sheila C. Bair, *The Case for Loan Modification*, 1 FDIC Q. 23, 25 (2007) (based on testimony before the H. Comm. on Fin. Servs.) (Despite the steep "payment shock" built into two- and three-year adjustable rate subprime hybrid loans, they performed reasonably well until last year because rapid rates of home price appreciation in many areas of the country allowed even highly leveraged borrowers to refinance or sell their home when the loan reset, masking the underlying weakness of the structure and underwriting of these loan products.).

337. *See* Emilio Augoulias, *What Future for Disclosure as a Regulatory Technique?: Lessons from the Global Financial Crisis and Beyond*, *in* THE FUTURE OF FINANCIAL REGULATION 18 (Iain MacNeil & Justin O'Brien eds., 2010) (noting the incredible and unjustified amount of trust placed in rating agencies); Steven L. Schwarcz, 93 MINN. L. REV. 373, 403 (2008)

338. Schwarcz, *supra* note 337, at 381–83.

339. MARTIN LOWY, HIGH ROLLERS: INSIDE THE SAVINGS AND LOAN DEBACLE 73 (1991). This is similar to immediate income generated by high fees on subprime loans and phantom income generated by payment option loans. In the 1980s this generated immediate income of approximately $4 billion in 1983 alone. *Id.* at 83; *see also* FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 184 (1997) [hereinafter HISTORY OF THE EIGHTIES], *available at* http://www.fdic.gov/bank/historical/history/167_188.pdf (finding that interest rates in construction loans are much higher than on other forms of lending and that regulatory accounting practices allowed savings and loan organizations to book loan origination fees as current income, even though these amounts were actually included in the loan to the borrower).

340. LOWY, *supra* note 339, at 75.

would agree to pay higher upfront loan fees for higher loan to value loans;[341]

- poor underwriting standards were employed including "window dressing" appraisals based on estimates of future value as well as developers' expectations;[342]
- the terms of construction loans, such as interest reserves funded by the bank itself and added to principal, delayed recognition of bad loans, i.e. loans made for buildings for which there was no market for a period of two to five years after the banks or savings and loans decided to make the loan;[343]
- auditors relied upon historical results of almost no losses at savings and loans on traditional single family mortgage loans and established no loan loss reserves for commercial real estate loans made at 100% of appraised value;[344]
- real estate developers leveraged their developments as never before, with syndicators putting up any equity a bank might require and therefore developers having no money in a project but retaining rights to 20% to 50% of profits.[345]

With little constraint imposed by fear of sanctions or market losses, the vague legal standard itself, and the more specific cautionary statements in regulatory guidance documents, become the ethical constraint on industry action.[346] Namely, the banking laws prohibit unsafe and unsound practices, and the FTC Act prohibits unfair practices. However, prior scholarship examining the ethical conduct of corporate actors found that a vague legal standard was ineffective in inducing corporate compliance.[347] This was especially true when sub-

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341. *Id.* at 77.

342. *Id.* at 73–75, 83; *see also* History of the Eighties, *supra* note 339, at 185 (finding that lending was based on overly optimistic appraisals). Similar practices were uncovered in the recent residential mortgage loan boom. *See, e.g.*, Press Release, N.Y. Attorney General Sues First American and Its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals (Nov. 1, 2007), *available at* http://www.ag.ny.gov/media_center/2007/nov/nov1a_07.html (describing e-mails which revealed a scheme in which a subsidiary of First American Corporation caved to pressure from Washington Mutual to use a list of preferred appraisers who provided inflated appraisals on homes).

343. Lowy, *supra* note 339, at 72.

344. *Id.* at 83; Lawrence J. White, The S&L Debacle 76 (1991).

345. Lowy, *supra* note 339, at 87.

346. *See* Am. Law Inst., Principles of Corporate Governance § 2.01 (1994) (requiring corporations to act within the boundaries set by law and to base their actions on an unduly literal reading of statutes and regulations, giving weight to policies and legislative purposes).

347. *See supra* Part I.B.

stantial enforcement risk and substantial sanctions for noncompliance were absent.[348]

C. The Dodd-Frank Act Revisited: Altering Industry Cost-Benefit Evaluations

The case study of the mortgage market experience presented in Part I.C of this article refutes the claim that principles-based regulation will necessarily lead to greater industry compliance and, in turn, legislative congruence. It documents that industry cost-benefit evaluations are critical to compliance. However, industry-cost benefit evaluations can lead to industry compliance and legislative congruence even when a principles-based regime is utilized. An earlier case study of the banking industry's compliance with the Community Reinvestment Act (CRA) documented the ability to change industry cost-benefit evaluations through effective enforcement measures, which led to legislative congruence in a principles-based regulatory regime.[349] The CRA uses principles-based regulation. The legal standard is a general one. The industry is obligated to serve the "credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution."[350] Between 1977 and 1988, the industry responded to this obligation largely by ignoring it. This was an era, however, in which the industry faced both a general standard and a lack of regulatory sanctions for violations.[351] By contrast, from 1989 to 2007, industry commitment to compliance with the CRA's mandate dramatically increased.[352] The nature of the legal mandate had not changed, indeed the banking regulators initially proposed to, but ultimately decided not to, adopt more objective criteria on which to judge compliance with regulatory requirements.[353] The frequency of regulatory sanctions and the actual and perceived severity of such sanctions was the primary difference

348. Di Lorenzo, *Business Ethics*, *supra* note 268, at 288–89; *see also* WHITE, *supra* note 344, at 115–17 (arguing that a lenient regulatory environment contributed to excessive rules violations).

349. Di Lorenzo, *Securities Industry*, *supra* note 267, at 799–803; Vincent Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millenium*,71 U. COL. L. REV. 51, 101–02, 116–120 (2000) [hereinafter Di Lorenzo, *Corporate Social Responsibility*].

350. 12 U. S. C. § 2903(a)(1) (2006).

351. *See* Di Lorenzo, *Securities Industry*, *supra* note 267, at 799–800; Di Lorenzo, *Corporate Social Responsibility*, *supra* note 349, at 89–90.

352. *See* Di Lorenzo, *Securities Industry, supra* note 267, at 799–803.

353. *See* Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156, 22,157 (1995).

between the two periods.[354] This is an example of strong sanctions imposed with some frequency overcoming the inability of principles-based regulation to induce corporate compliance.

A more recent lapse in industry compliance illustrates the failure, at times, of a rules-based regulatory system to induce compliance when there is a failure of oversight and enforcement. Congressional hearings document that major mortgage servicers, including Bank of America, GMAC Mortgage, and Wells Fargo, ignored legally required procedures in mortgage foreclosure actions.[355] This included claiming personal knowledge of information regarding mortgages foreclosed, such as amounts due, without verifying such information, as required under state law,[356] and backdating documents or failing to provide documents establishing plaintiffs' interest in the mortgage being foreclosed, also required under state law.[357] This failure to comply with legal mandates occurred in a legal environment in which legal obligations were clear—a rules-based regulatory environment. Yet major banks ignored the legal mandates, in part because compliance was not closely monitored and, until recently, no sanctions were imposed.[358] A similar failure to comply with clear legal requirements was also documented by Katherine Porter in her analysis of 1,700 consumer bankruptcy cases filed under Chapter 13.[359] She found that 52.8% of filed claims did not include one or more attachments regarding proofs of claim, which are unambiguously required under the bankruptcy law.[360] Porter noted that in most cases, lack of scrutiny by the courts leads to no negative consequences for creditors failing to comply with clear legal mandates.[361]

The conference report on the Act recognized that effective consumer protection depends upon laws and regulations that are "compre-

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354. Di Lorenzo, *Securities Industry*, *supra* note 267, at 800–03; *see also* discussion of response to government sanctions with regard to securities law violations in Japan and Europe. *Id.* at 798. A detailed discussion of the agencies' increasingly frequent imposition of legal sanctions and the banking industry's response is found in Di Lorenzo, *Corporate Social Responsibility*, *supra* note 349, at 92–104.

355. CONG. OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: EXAMINING THE CONSEQUENCES OF MORTGAGE IRREGULARITIES FOR FINANCIAL STABILITY AND FORECLOSURE MITIGATION 4, 7–14 (2010), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT61835/pdf/CPRT-111JPRT61835.pdf [hereinafter NOVEMBER OVERSIGHT REPORT].

356. *Id.* at 11.

357. *Id.* at 14–16.

358. *See supra* notes 316–32 and accompanying text.

359. Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 146 (2008)

360. *Id.*

361. *Id.* at 172.

hensive, fair, and vigorously enforced."[362] Industry cost-benefit evaluations of the risk of sanctions are based on the likelihood that noncompliance or evasion will be discovered, through an examination process, the sanctions that are made available to regulators, and the enforcement record, including the frequency and type of sanctions imposed.

A starting point for industry evaluation of the likelihood of sanctions is regulatory authority over lending operations that may uncover violations of regulatory requirements. The Act grants the Bureau the power to require, on a periodic basis, reports and conduct examinations of mortgage originators and brokers,[363] including originators and brokers that are unaffiliated with depository institutions.

A second basis for the evaluation of the likely effect of the new statute on corporate compliance requires an analysis of available sanctions. Title 10 of the Act grants the Bureau the power to seek relief for a violation of the "federal consumer financial law."[364] The available forms of relief include rescission or reformation of contracts, refund of moneys or return of real property, restitution, disgorgement or compensation for unjust enrichment, payment of damages or other monetary relief, public notification regarding the violation, including the costs of notification, limits on the activities or functions of the person, and civil money penalties.[365] The civil monetary penalties permitted are the same three-tiered monetary penalties currently permitted under the federal banking law, except that the basis for imposition of the second and third tier penalties is simplified.[366] First tier penalties of $5,000 for each day a violation continues can be imposed for "any violation of a law, rule, final order, or condition imposed by the Bureau."[367] Second tier penalties of $25,000 for each day a violation continues can be imposed for any person that "recklessly engages in a violation."[368] Third tier penalties of up to $1 million for each day a violation continues can be imposed for any person that "knowingly violates" a federal consumer financial protection law.[369]

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362. H.R. Rep. No. 111–517, at 874 (2010) (Conf. Rep.).
363. *Id.* at 623.
364. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1002 (12), (14), 124 Stat. 1376, 1955–64 (2010) (codified at 12 U.S.C. § 5481) (including Title 10 of Dodd-Frank and the Truth in Lending Act, as amended by Title 14 of the Dodd-Frank Act).
365. § 1055(a)(2), 124 Stat. at 2030. The statute does not authorize imposition of exemplary or punitive damages. § 1055(a)(3), 124 Stat. at 2030.
366. *See* Monitoring of IndyMac, *supra* note 326.
367. § 1055(c)(2)(A), 124 Stat. at 2030.
368. § 1055(c)(2)(B), 124 Stat. at 2030.
369. § 1055(c)(2)(C), 124 Stat. at 2030.

In addition to the forms of relief authorized under Title 10 of the Act, Title 14 amends the Truth in Lending Act to authorize additional relief.[370] For a violation of the minimum underwriting standards imposed by the Act, or the prohibition against compensation of mortgage brokers based on the terms of the loan (steering), the Act allows a consumer to raise such violation "as a matter of defense by recoupment or set off" in any judicial or non-judicial foreclosure of a residential mortgage loan.[371] The amount of recoupment or set-off is equal to the amount that the consumer would be entitled to recover under the civil liability provisions of the Truth in Lending Act. This includes recovery of any actual damages sustained,[372] plus the costs to the consumer of the action, including reasonable attorney's fees.[373] The statute permits recovery of damages in class actions as well[374] not to exceed the lesser of $1 million or 1% of the net worth of the creditor.[375]

It is helpful to compare the available remedies under the Act with the available remedies under current federal banking laws. One significant change is that the sanctions authorized by the Act apply to all creditors engaged in consumer credit, and not just insured depository institutions.[376] However, banking institutions failed to comply with the statutory prohibition against unsafe banking practices, as well as agency guidelines warning institutions against making loans without regard to ability to repay, despite the risk of possible sanctions authorized under existing federal banking laws. The question raised is whether the severity of available sanctions has changed sufficiently to alter industry cost-benefit evaluations.

The sanctions that were available to the federal banking agencies between 2002 and 2008 included termination of deposit insurance;[377] cease and desist orders, including an order seeking restitution for loss, limiting the activities or functions of an insured institution, and re-

370. §§ 1400–1498, 124 Stat. at 2136–2211.

371. § 1413, 124 Stat. at 2148–49.

372. 15 U.S.C. § 1640(a) (2006).

373. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1413, 124 Stat. 1376, 2148–49 (2010) (amending 15 U.S.C. 1640).

374. 15 U.S.C. § 1640(a)(2)(B) (2006).

375. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1416(a), 124 Stat. 1376, 2153 (2010) (amending 15 U.S.C. § 1640(a)) (increasing civil liability amounts under 15 U.S.C. § 1640(a)(2)(B)).

376. § 1411, 124 Stat. at 2142–45; 15 U.S.C. § 1602(f) (2006).

377. 12 U.S.C. § 1818(a)(2) (2006) (insured institution has engaged or is engaging in unsafe or unsound practices, or has violated any applicable law, regulation, order, condition imposed in writing or written agreement with the FDIC).

scinding agreements;[378] removal of any director, officer, employee or controlling stockholder, as well as industry-wide prohibition;[379] and imposition of civil monetary penalties.[380] This final sanction could be imposed for, among other violations, violation of any condition imposed or written agreement with a federal banking agency and any cease and desist order, including an order pursuant to standards issued by the appropriate federal banking agencies for safety and soundness.[381]

The Act increases the risks presented to the industry primarily by simplifying the prerequisites for imposition of second and third tier civil monetary penalties.[382] For second tier penalties, the Act removes the need to prove that the violation is part of a pattern of misconduct, or likely to cause more than minimal loss to the institution, or likely to result in pecuniary gain to the violator. For third tier penalties, the Act removes the need to prove the violation causes a substantial loss to the depository institution or results in a substantial gain to the violator.[383]

A third basis for industry re-evaluation of the risks versus the benefits of compliance or noncompliance is the likelihood that sanctions will actually be imposed. This is the most important aspect of industry evaluation of risks versus benefits of noncompliance or evasion. Such evaluation is based on a review of the parties that may seek a sanction and the potential plaintiffs' record in seeking and obtaining particular sanctions. The Act allows private parties to assert a violation of the Act's minimum underwriting requirements as a defense by recoupment or set-off.[384] Currently, possible violations of underwriting standards by banking institutions can only be enforced by the federal banking agencies.[385] The Act also allows enforcement actions to be commenced by state attorneys general, when they seek to enforce

378. § 1818(b)–(d).

379. § 1818(e). This provision applies to institution-affiliated parties that engage or participate in any unsafe or unsound practice. "Institution-affiliated party" is defined in 12 U.S. C. § 1813(u) (2006).

380. § 1818(i)(2).

381. *Id.*

382. *Compare* 12 U.S.C. § 1818(i)(2) (2006), *with* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1055(c)(2), 124 Stat. 1376, 2030 (2010) (codified at 12 U.S.C. § 5565).

383. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1055(c)(2), 124 Stat. 1376, 2030 (2010) (codified at 12 U.S.C. § 5565).

384. § 1413, 124 Stat. at 2149 (amending 15 U.S.C. § 1640).

385. *See, e.g.*, 12 U.S.C. § 1818(i) (2006); *see also* Truth in Lending, 73 Fed. Reg. 44,522, 44,528 (July 30, 2008) (indicating that consumer protections enforceable by both federal and state authorities in addition to borrowers is new).

the provisions of Title 10 or 14.[386] Finally, it transfers and centralizes enforcement authority over various consumer financial protection laws in the Bureau.[387] The pool of available parties is no longer limited to the federal banking agencies, the FTC and, at times, private parties. It now includes the newly established Bureau and all fifty states' attorneys general.

Enactment of significant potential penalties and expansion of the pool of available plaintiffs might be expected to induce corporate compliance in the short term by altering industry perception of the possible risk of liability. However, in the long term, industry evaluation of the risks of legal sanctions depends upon the actual enforcement record of all of these participants, and especially the Bureau. While the federal banking laws permit imposition of civil monetary penalties, the actual, typical practice among the federal bank regulators was to resort to informal agreements, then formal agreements, and then cease and desist orders prior to imposition of more severe penalties including civil monetary penalties, which were rarely imposed.[388] Industry members realized that no civil monetary penalties would actually be imposed until they were notified of a violation and given the opportunity to correct it. Industry cost-benefit evaluations were based on these practices.

Whether the Act will actually modify industry cost-benefit evaluations, and therefore industry actions, is uncertain. Future enforcement decisions made by the Bureau and state attorneys general, including

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386. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1042, 124 Stat. 1376, 2012 (2010); § 1422, 124 Stat. at 2157 (amending 15 U.S.C. § 1640(e)).

387. § 1061, 124 Stat. at 2035 (codified at 12 U.S.C. § 5581).

388. *See* Brunmeir & Willardson, *supra* note 316, at 27 (Most enforcement actions against institutions are "concentrated in areas of cease and desist orders and written agreements, with civil money penalties falling far behind."); Civil Rights Issues, *supra* note 312, at 8 n.28 (outlining possible penalties); Davenport, *supra* note 316 (describing the OCC's typical course of action as beginning with advisory letters, advancing to cease and desist orders and ending with civil monetary penalties); Ip & Paletta, *supra* note 311 (finding that "public disciplinary actions against subprime lenders are rare" and typically include cease and desist orders); MONITORING OF INDYMAC, *supra* note 327, at 38 (indicating that a memorandum of understanding was one of the only enforcement actions taken before the closing of IndyMac); Office of the Comptroller of the Currency Consent Order, *supra* note 309 (requiring repayment and restitution but not imposing penalties); OVERSIGHT OF WASHINGTON MUTUAL, *supra* note 138, at 29–33 (arguing that OTS should have relied upon formal enforcement actions rather than informal enforcement actions in its oversight of WaMu); Statement of John C. Dugan, *supra* note 316, at 3–10 (outlining OCC's enforcement approach and stating that OCC uses informal enforcement actions, such as memoranda of understanding, more often than formal enforcement actions).

how frequently and what sort of sanctions they will seek for violations, will play a critical role in answering that question.

Conclusion

The public policy debate regarding the preference for principles-based or rules-based regulatory structures to achieve legislative congruence ignores the important role, often determinative role, of government enforcement measures. The debate ignores that industry decisions regarding compliance with or evasion of legal mandates depends on cost-benefit evaluations, with the risk and severity of sanctions playing an important role in such evaluations. This article calls for a recognition of this decision making model. Substantial sanctions coupled with robust enforcement policies can make mortgage originators risk-averse, and therefore more likely to comply with both rules-based and principles-based regulations. By contrast, weak sanctions or weak enforcement policies can convince industry actors to evade or, at times, blatantly not comply with either principles-based or clear risk-based regulations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act reaffirms the importance of Congress' twin goals of safety and fairness in the credit markets. It also re-imposes rules-based regulations and strengthens available sanctions. Whether it will usher in a new era of robust consumer protection in the credit markets, however, is uncertain and will largely depend upon the new Consumer Financial Protection Bureau's commitment to oversight and the Bureau's choice of sanctions.