Inflexible Uncertainty: Regulatory Structure and Mortgage Regulation under Dodd-Frank

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I. Introduction

In enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) and creating the Consumer Financial Protection Bureau (“CFPB”), Congress and the Administration have solved two problems while creating at least two others. On the one hand, as intended, consumer protection has a powerful new champion. Additionally, sweeping reforms were enacted at the time that Congress had the political will and the Administration had the political capital to enact them, without taking the time (and suffering the accompanying delay) required to make difficult decisions on things like which specific mortgage products should be prohibited or discouraged and how credit risk retention should work.

On the other hand, the result is an all-powerful agency that has little outside accountability, imposing substantial burdens on the mortgage industry that appear disproportionate to the market failures they address, as well as overlapping regulatory provisions that have the potential of over-regulating the market in such a way that the traditional regulatory choice between flexibility and predictability gives way to rigidity without predictability. Both of these phenomena seem poised to have a severe and negative effect on the availability of credit to consumers, in particular the poor and lower middle class.

An examination of the power and structure of the CFPB, and of two of the most important regulatory proposals under Dodd-Frank—Qualified Mortgages and the Ability to Repay, and Qualified Residential Mortgages and Credit Risk Retention—illustrate the potential perils of Dodd-Frank’s approach to mortgage regulation for the residential mortgage market and for all but its wealthiest consumers.

Although many of the problems arise from the statutory scheme, the CFPB and stakeholders can mitigate the potential for decreased access to credit, by understanding the
structural and institutional sources of the problem and resisting the urge to prescribe suffocation as the remedy for potential gaps in regulatory coverage.

II. **Regulatory Overload and the All-Powerful CFPB**

Few figures in American public life represent a more powerful and less-constrained actor than the special prosecutor, brought in to enforce the law against the powerful, freed from political and fiscal limitations. Now, imagine a “super” special prosecutor who can also write the very law that he enforces, who can investigate without needing warrants or subpoenas (but who may use those instruments as well), and who acts as judge and jury with respect to the very charges he brings, subject only to highly-deferential judicial review. That super special prosecutor is the Director of the Consumer Financial Protection Bureau (“CFPB”).

The combination of the powerful and multi-faceted CFPB with the expanding activity of state regulators and attorneys general is quickly leading to a situation where even non-bank mortgage companies are always being examined and investigated. To make matters worse, Congress and the Administration’s effort to avoid any regulatory gaps is leading to increased potential for regulatory conflict at the federal level alone, which, paradoxically, tends to yield both a lack of flexibility and an absence of predictability. Finally, while the CFPB was designed to avoid regulatory capture by industry (some had accused the banking regulators of conflating the views and goals of the banking industry with the public good), the very features that avoid weakness and capture also inhibit accountability, and result in what some would characterize as

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capture by ideologically-driven consumer advocates or political opponents of the mortgage industry.

A. The 365-Day Examination

Supervision can be an important tool for regulating the mortgage industry, providing what is ideally a cooperative and confidential arena for improving regulatory compliance. Moreover, Dodd-Frank provides for supervision of non-bank lenders in part to promote regulatory uniformity of companies no matter how they are organized or chartered.

Yet, despite statutory provisions intended to decrease the burden of examinations, lenders and servicers are beginning to face what can only be characterized as a never-ending series of 365-day examinations, where they are constantly undergoing examinations and/or investigations by different regulators or even by different arms of the same agency. That is the combined effect of the CFPB’s enforcement investigations (in particular through burdensome Civil Investigative Demands) and the CFPB’s supervisory examinations (comprising initial “scoping” reviews marked by visits that can last for weeks, preceded and followed by voluminous document requests, and then followed by formal examinations which can last for months), along with increased examinations and investigations by state regulators, state attorneys general, and multistate committees of state regulators, to say nothing of other federal agencies, including the Federal Trade Commission and HUD Inspector General.

The cost of these 365-day examinations is substantial, and is very different, qualitatively, from the costs associated with compliance with substantive statutes and regulations. The constant presence of these regulators and investigators, whose rules require speedy and comprehensive responses to every request or inquiry, requires companies to add large numbers of staff in their compliance departments. This additional staff does not help the employer
comply with substantive laws or regulations, nor would perfect compliance with all substantive regulations relieve companies of the need to hire them. Rather, their purpose is solely to respond to and serve the ever-present regulators. Small (or lean) companies may not be able to afford to comply. This phenomenon of “too small to comply” has the potential to limit consumer choice if fewer large firms (offering fewer products) dominate lending. Companies who attempt to cope with the mountain of regulatory change by investing substantially in compliance-promoting systems, or by retaining outside vendors to help them track and comply with regulatory requirements, cannot innovate around this substantial burden. Those who fail to staff up invite conflict with regulators, in particular the CFPB, which has taken a hard-nosed and frankly disturbing approach to extensions of time and reasonable accommodations in investigations and examinations.

B. How Did We Get Here?

At the root of the CFPB’s unprecedented power, and the patchwork of potentially-contradictory rules and standards, discussed below, was Congress’s decision to punt, leaving many of the details of financial regulatory reform to rulemaking and enforcement decisions by agencies including the newly-created CFPB.

Congress lacked the political will to make certain difficult decisions about which product and services, which features and which practices, should or should not be prohibited because of their social effects. Congress and the Administration nonetheless wanted strict regulations and

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forceful enforcement against perceived abuses in the consumer financial services industry.\(^3\) As a
result, they have created and empowered a regulator that can be relied upon to make strict
regulations and take forceful enforcement actions because of its extreme pro-consumer
orientation. The trade-off is the potential for a lack of balance, resulting not only in a greater
regulatory burden on industry, but in decreased choice and access to credit for consumers.

C. Behavioral Economics, Transparency and Institutions

It has been observed that Dodd-Frank and the CFPB are based in large part on the
premise, from the field of behavioral economics, that consumers’ cognitive biases prevent them
from making rational financial choices, even when they are provided with complete information.
Cognitive biases are defects in the ways people perceive the world that tend to result in their
making decisions that are not rational. Such biases include payment/interest bias, which
 describes how consumers systematically underestimate the Annual Percentage Rate (APR) of a
loan based on the amount of the monthly payments,\(^4\) and anchoring, where individuals are
influenced in making estimates or choosing fair outcomes by an “anchor” number that is
suggested to them, perhaps the starting offer in a negotiation.\(^5\) One commentator has suggested
that Dodd-Frank’s focus on cognitive bias constitutes a rejection of traditional economics, which
teaches that the choices made by consumers reveal the consumers’ preferences, as long as the
consumers have the necessary information.\(^6\) We think this objection is overstated, but it does

\(^3\) Cf. Baer, Miriam H., *Choosing Punishment*, 92 B.U. L. Rev. 577 (March 2012) (Arguing that enforcement is
politically easier than regulation and some regulated entities may even prefer it.).


Series, Vol. 185, No. 4157 (Sep. 27, 1974), pp. 1124-1131.

Yale L.J. 2216 (June 2012).
provide a useful way of looking at the potential inconsistency inherent in Dodd-Frank’s scattershot approach to consumer protection regulation.

On the one hand, Dodd-Frank does build on an understanding of cognitive bias in envisioning the prohibition of products that consumers would choose (even with full disclosures), but regulators think they should not choose. On the other hand, neither Dodd-Frank nor the CFPB is ignoring traditional economics, and in fact, both focus a great deal of attention on market failures caused by misleading or incomplete information about consumer financial products and services. The coming revolution in disclosures⁷—to say nothing of the massive education campaigns provided for by the law and conducted by the CFPB⁸—is ample evidence that Congress and the Administration saw the value and importance to consumers of transparency and education (and that they do not believe that consumers are generally incapable of making rational choices).

Moreover, despite the problems identified in this paper, Congress and the Administration were clearly aware of the potential for decreased access to credit as a result of the Dodd-Frank reforms and of the CFPB’s actions in the future. The requirement for cost-benefit analyses—both at the rulemaking stage, and as a periodic follow-up—is a good example of this.⁹ Somehow missing from this awareness (itself an application of traditional economics, whereby restrictions on product terms will lead to decreased supply), however, is an appreciation of the need—as described in the field of new institutional economics—not only for good substantive rules, but for the underlying “rules of the game,” such as regulatory norms and enforcement mechanisms,

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⁷ E.g., the forthcoming integrated Truth in Lending and real estate settlement disclosures, discussed at http://www.consumerfinance.gov/knowbeforeyouowe/.
⁸ E.g., the Office of Financial Education, created by § 1013(d) of Dodd-Frank.
⁹ Dodd-Frank § 1022(b)(2)(A) (requirement of cost-benefit analysis in rulemaking); § 1022(d) (requirement to revisit rules after five years).
to provide predictability for market participants. What matters are not only the substantive requirements, but how those requirements are enforced and by whom, the predictability of the outcome of such enforcement and the ability of private actors to make and enforce commitments to order their dealings in the marketplace.

At bottom, it makes sense for the framers of Dodd-Frank to have incorporated important ideas and insights from multiple fields, including behavioral economics, into their vision of an evidence-based regulatory regime. But it is important to remember that the amalgamation of multiple valid proposals is often less beneficial than the sum of those proposals if enacted individually. Assessing and understanding the cumulative impact of the substantive regulations, resulting norms, enforcement and supervisory systems on the ability of private actors to order their affairs and on their willingness to do so is just as important as solving microeconomic market failures resulting from a lack of useful and complete consumer information and from cognitive bias (even in the presence of such information). Application of multiple inconsistent paradigms may end up not as the best of each field, but rather as a quagmire for market innovation. Institutions, and not only market transactions, matter.

D. The Other Regulatory Capture

The CFPB was designed with an eye to avoiding the perceived ineffectiveness of the Consumer Product Safety Commission and to avoid the regulatory capture associated—rightly or wrongly—with certain regulators of depository financial institutions, regulators of polluters, and others. But regulatory capture—regulators and industry sharing a common outlook, or regulators promoting the interests of the industry—can be quite normal where the regulated

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entity provides a quasi-public good, such as helping increase home ownership. And regulatory capture, properly understood, is not limited to industry. Capture by other interest groups, such as those promoting aggressive visions of consumer rights, can have equally-distorting effects on the market.

Dodd-Frank was so focused on avoiding capture by industry, however, that it created a CFPB that is not subject to any meaningful external checks or balances. The CFPB Director has vast power and is only removable for cause. Most of the CFPB’s budget is automatically provided from the Federal Reserve, without the need to obtain funding through appropriation (or submit to meaningful Congressional oversight). The CFPB can litigate independently without the permission of the White House, anywhere other than the U.S. Supreme Court. And the CFPB has such broad rulemaking and other authority, including nearly limitless provisions barring “unfair deceptive or abusive acts and practices,” and even the right to prohibit practices that are not themselves objectionable, but which the CFPB believes increase the risk of objectionable practices (so-called prophylactic rules). The CFPB is made up of dedicated public servants who will hopefully respond to criticism, suggestions and concerns, but the fact remains that the only external checks on its power are judicial review under the Administrative Procedure Act, which is highly deferential and which—for a variety of reasons—is unlikely in most cases, and a systemic risk veto that requires such a consensus among a counsel of regulators that is unlikely to be invoked even in extreme cases. The most effective check may end up being the CFPB’s fidelity to Dodd-Frank’s directive to consider and balance the effects of its proposed regulations on access to credit.

The result—by design—is a regulator so focused on protecting consumers from lenders that it appears poised to take credit and opportunities away from those same consumers, with potentially devastating implications for home ownership in this country. And because of the CFPB’s structure, the only check may be itself.

III. **Like Oil and Water: A Statutory Emulsion of Rules and Standards**

It is often useful to describe legal restrictions as being divided into rules, which are specific provisions stating what is and is not allowed or required, and standards, which are general principles by which actions or inaction are judged after the fact.12

Rules and standards each have their advantages. Among other things, it is easier to determine how to comply with a rule, and it is easier to be confident that one has complied with the rule, which enhances predictability. Predictability encourages investment, which is good for economic growth. Standards, by contrast, may be cheaper to create (there is less of a need to consider multiple factual scenarios and to decide what exactly to do in each situation), and—if properly crafted and applied—should reach desirable outcomes more often, even in circumstances that were not predicted or predictable at the time they were issued. Standards allow for more innovation in the marketplace than do broad rules, which also is good for economic growth, and standards leave open whether new products or services will comply with the law. In short, rules may restrict innovation, but provide predictability and protection from litigation and regulatory enforcement. Standards permit innovation but may restrain investment by leaving regulatory uncertainty.

The literature recognizes that some laws and regulations fall in the middle of that spectrum, and that even the most specific rule cannot envision all possible conduct or

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circumstances. Some have plausibly argued that the choice between rules and standards is a false choice because rules and standards “converge” as applied within legal and social institutions. Yet the distinction remains valid and important, in particular when examining the interplay of overlapping rules and standards.

The advantages of rules come from their being rules and not standards. Likewise, the advantages of standards come from their being standards and not rules. By applying both rules and standards to the same conduct or to the same products and services, one is left (from the perspective of both industry and consumer access to the market) with the disadvantages of both and the key advantages of neither. The rule restricts innovation and the standard takes away predictability.

By refusing to make choices among rules and standards, and by trying to avoid any potential “under-regulation” by giving multiple overlapping and potentially-inconsistent directives and tools to the CFPB, Congress and the Administration may have unintentionally chosen paralysis and decreased market activity. The potential effects of overlapping rules and standards are discussed with reference to ability to repay and risk retention, below.

IV. Drastically Limiting Mortgage Options—QM/QRM

The tensions described above between bright-line rules and amorphous standards, as well as the problems that arise when solutions are presented where the problem is not yet clear, can easily be seen by examining the CFPB’s proposed ability to repay regulations and the multi-agency proposed risk retention regulations, both mandated by Dodd-Frank.

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A. Ability to Repay and Qualified Mortgages

The CFPB’s proposed ability to repay regulations, in fact, combine rules and standards in the same set of proposed regulations. Dodd-Frank amended the Truth in Lending Act (“TILA”) to require that a creditor must determine a consumer’s ability to repay when making a residential mortgage loan, which is a standard. Dodd-Frank also provided a presumption of compliance with this requirement for so-called “qualified mortgages” (“QMs”) that meet certain features; i.e., a rule. Considering the consumer’s ability to repay is obviously important, and makes sense for both the creditor and the consumer. However, there are serious potential problems with the system as it is being proposed.

The CFPB’s proposed ability to repay regulations would implement Dodd-Frank’s ability to repay requirements, and simultaneously propose alternative definitions for QMs. A “safe harbor” QM would not include the full gamut of underwriting criteria set forth in Dodd-Frank, and would instead only focus on and require such loan terms as the mortgage fully amortizing, the mortgage not exceeding 30 years, the total points and fees not exceeding a certain amount (3% for loans of $75,000 or more), and the basic underwriting criterion of the creditor considering and verifying the consumer’s current or reasonably expected income or assets. A “rebuttable presumption” QM, on the other hand, would require the loan terms above plus would establish additional underwriting criteria for the creditor, including consideration of employment status, simultaneous loans, current debt obligations, and credit history, and it would permit the consumer to rebut the creditor’s assertion that the loan in question was a QM.

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15 Regulation Z; Truth in Lending, 76 Fed. Reg. 27,390, 27,454 (May 11, 2011) (note that the proposed rule was published by the Board of Governors of the Federal Reserve System, and has since been transferred to the CFPB).
16 Id.
The differing QM proposals highlight the potential rules/standards problem. Both QM definitions are rules, rather than standards. The “safe harbor” QM definition does not provide for as many bright-line definitional criteria as the “rebuttable presumption” QM definition, but it does have the benefit of providing creditors with a rule-based, demonstrable ability to show compliance with the ability to repay standard (more on that below). The “rebuttable presumption” definition, on the other hand, is a toothless rule because compliance with that rule does not provide immunity from application of the comparatively vague ability to repay standard. With a rebuttable presumption, violation of the standard can trump compliance with the rule.

Dodd-Frank further amended TILA to provide that a consumer in foreclosure can raise the creditor’s failure to consider the consumer’s ability to repay as a defense by recoupment or set-off with no time-limit, allowing the successful consumer to collect the sum of all finance charges and fees paid by the consumer as well as actual damages and twice the amount of any finance charge in connection with the transaction.17

B. Ability to Repay - The Credit Stream Runs Dry

As many have already observed, the most likely outcome of this provision of Dodd-Frank, together with the proposed regulations, will be vastly increased litigation costs in the face of foreclosures.18 In addition, non- QM loans could run afoul of stringent HOEPA requirements due to the proposed lowering of HOEPA points and fees triggers19, and depository banks would likely have to retain large amounts of capital against such loans under the proposed Basel III

17 15 U.S.C. §§ 1640(a), (k).
18 See The Coming Crisis in Credit Availability, Amherst Mortgage Insight (May 30, 2012).
implementation rules. In the face of such potential costs, creditors will be severely disinclined to make anything other than a QM.

Even with respect to QMs, the costs of potential litigation will likely be passed on to the consumer, since realistically a consumer in foreclosure will always be able to allege a violation of the broad ability to repay standard, even in the face of the assertion of the QM rule. A “safe harbor” QM is not necessarily more “safe” than a “rebuttable presumption” QM in this regard; a creditor in court will not simply be able to assert that a loan is a “safe harbor” QM, but will instead have to demonstrate that the loan met the “safe harbor” QM’s somewhat amorphous definitional criteria, which will by necessity increase the cost of making the loan for the creditor. A “rebuttable presumption” QM presumably would be easier for a creditor to defend to the extent that it includes more bright-line definitional criteria, but would of course explicitly permit the consumer to attempt to rebut the presumption of compliance.

It is not clear whether Congress, through Dodd-Frank, intended to protect society as a whole by preventing the writing of bad mortgages that could have a cascade effect through the national financial system, or whether Congress paternalistically sought to protect consumers from the consequences of their own bad decisions. It is also not clear whether the ability to repay solution even addresses the primary cause of the global financial collapse; while many have speculated that the root cause of the bubble growth was unscrupulous creditors lending to unwary consumers, there is credible evidence to suggest that there were in fact many causes, and

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that the primary cause may have been opacity and lack of clarity with respect to mortgage-
backed securities in the secondary market.\textsuperscript{21}

Whatever Congress’s intent, the likely outcome seems clear: Increased costs for those
consumers who are able to receive QMs (as well as a lack of choice in mortgage products for
such consumers), and a dearth of credit for everyone else. In trying to deter writing loans to
consumers who are bad credit risks, Congress and the CFPB have instead steered too close to
shrinking the supply of credit to vast portions of the population. This does not even touch on the
real risk of creditors running afoul of the CFPB and HUD’s incredibly broad fair
lending/disparate impact standards, in their efforts to avoid expensive litigation by complying
with the QM rule.

C. Ability to Repay – Limit the Defense

In the interests of not drying up the stream of credit for the majority of potential
homebuyers, it appears that there are certain steps the CFPB can take despite the mandates of
Dodd-Frank, through the exercise of its broad rulemaking authority and full Chevron
deference.\textsuperscript{22} One major step the CFPB should consider is implementing a regulation limiting the
TILA defense to foreclosure provision to a discrete period of time after the loan is made, with
two or three years probably being the most feasible option. As noted above, TILA currently
permits a consumer to assert that the creditor failed to consider the consumer’s ability to repay in
a foreclosure action with absolutely no time limit, which is problematic. A consumer who has
regularly met his or her mortgage obligations for 25 years, only to enter foreclosure in the 26th
year because of an unforeseen calamity, clearly and demonstrably had the ability for the vast

\textsuperscript{21} See Levitin & Wachter, Explaining the Housing Bubble, 100 Geo. L. J. 1177 (April 2012).
\textsuperscript{22} 12 U.S.C. § 5512.
lifespan of the loan to repay it. On the other hand, a foreclosure within the first two or three years of the lifespan of the mortgage could credibly indicate a failure on the creditor’s part to properly analyze the consumer’s ability to repay. Limiting the lifespan of the defense to this period would, therefore, protect both consumers and creditors. Additionally, it would likely bring down the expected costs of the ability to repay rules; a loan that only has litigation risk in the first two or three years for ability to repay issues would likely be much less costly than a loan bearing such risks for its entire life.

D. Risk Retention and QRMs - The Big Get Bigger

All of the potential problems identified above will likely be amplified by the proposed multi-agency risk retention regulations, which would generally require that any person who securitizes assets (which could include a mortgage loan originator) must retain at least 5% of the credit risk of the securitized assets, and is generally not permitted to hedge this risk away. Securities based on “qualified residential mortgages” (“QRMs”) would not be subject to this requirement, nor would securities based on loans insured by the Federal Housing Administration (“FHA”).23 While the CFPB is not in control of the risk retention regulations, it is important to note that because the definition of a QRM cannot be broader than that of a QM, the CFPB will indirectly control the definition of the QRM by defining the QM.

The idea of “skin in the game” for securitizers is an admirable one, especially to the extent that it prevents securitizers from shifting hidden credit risk to investors through complex securitization procedures. However, the proposed rules as drafted would likely have as dramatic an effect on the availability of credit as the ability to repay requirements. Smaller lenders likely would not be able to write proportionately as many non-QRM loans, because their smaller

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amount of available collateral would be eaten up more quickly by the risk retention requirement for non-QRM loans (even if a creditor is not a “securitizer” for purposes of risk retention, the proposed rules would permit the securitizer to allocate its retained risk to the originator of the loan, and most securitizers would likely require this as a prerequisite for securitizing an originator’s loans).

On the other hand, the credit overlay requirements of QRMs, such as a 20% down payment requirement, and front-end and back-end ratios of 28% and 36%, respectively, would severely limit the ability of most consumers to obtain a QRM. Such consumers would either have to go to the largest lenders, further concentrating economic growth in those lenders contrary to governmental policy, or would be pushed into FHA-insured loans, which is itself problematic from a policy standpoint and would further tax the FHA’s already-stretched resources (not to mention increasing the compliance costs and risk for lenders who are not already familiar with FHA’s sometimes-Byzantine set of requirements).

E. Risk Retention - Hedging and Transparency

One easy step the agencies responsible for the risk retention rules should consider is permitting securitizers (or originators when risk is allocated to them) to hedge some or all of their retained risk (which the agencies are expressly permitted to do).24 If done in tandem with reformed securitization requirements designed to ensure that investors can be ensured of greater transparency of asset-backed securities so that they can properly price risk, this would likely go a long way to addressing one of the core causes of the housing bubble growth and collapse, while at the same time ensuring that credit availability does not wither away for most consumers.

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V. Concluding Thoughts

While some blame the CFPB for the regulatory quagmire in which the mortgage and housing industries find themselves, and while the CFPB is responsible for choosing between the QM proposals as well as for aggressive enforcement and examination positions that it appears to be taking, the essential problem is contained in Dodd-Frank itself. In rushing to simultaneously “fix” everything about the mortgage industry and avoid any possibility that undesirable conduct could go un-prohibited, while avoiding difficult substantive decisions, Congress and the Administration set the path that the CFPB is now bound to follow.

Nevertheless, it appears that there are some options available to the CFPB and to other agencies that could ameliorate what appears to be the clearly-coming negative impact on credit availability and price. As discussed above, for example, the CFPB could consider a time limit on foreclosure defenses, while the agencies tasked with implementing risk retention could permit hedging, in tandem with other actions.

Where we go from here depends on all of the stakeholders coming together and focusing on issues of flexibility and predictability, giving the mortgage industry room to find ways to serve more consumers while protecting consumers and society from the abuses that characterized parts of the mortgage market during the lead-up to the crisis. And it will depend on the ability of Congress and the CFPB (and other regulators) to make laws and regulations governing the industry based on an understanding of the effects of those laws and regulations, and not simply based on politics or ideology. It is not an easy path, but with Dodd-Frank enacted and the CFPB in place, consumer advocates can rest assured that consumers will be protected from lenders, if only we can find a way to give them the ability to become consumers in the first place.