

# BARRIERS TO MARKET DISCIPLINE: A COMPARATIVE STUDY OF REGULATORY REFORMS

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## I. INTRODUCTION

In recent years many nations faced a mortgage crisis manifest in significant levels of borrower defaults leading to substantial losses for homeowners and the financial services industry. Years after this crisis surfaced, nations around the globe are still struggling to formulate the proper regulatory modifications that can, hopefully, avoid a recurrence of the unsafe lending practices that were the underlying cause of the current crisis. The formulated responses have come in two forms: (a) product reforms, primarily new regulatory requirements in underwriting practices, and (b) supervisory reforms, primarily modified enforcement policies. Regulatory reforms are currently under consideration in nations that witnessed substantial numbers of defaults and losses, such as the United States, Ireland and the United Kingdom. They are also under consideration in nations, such as Canada, that did not witness such consequences but seek to ensure they do not arise in the future.

In the United States, the primary emphasis has been on product reforms. In Canada, the primary emphasis has also been product reforms.<sup>1</sup> In the United Kingdom, some product reforms have been proposed but the primary emphasis has been on supervisory reforms. Ireland has similarly embraced a reform agenda

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1. See, e.g., OFFICE OF THE SUPERINTENDENT OF FIN. INSTS., GUIDELINE: RESIDENTIAL MORTGAGE UNDERWRITING PRACTICES AND PROCEDURES 7–8, 10–11 (2012) (Can.), available at [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/b20\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/b20_e.pdf) (calling for board approved residential mortgage underwriting policies that include verification of borrower's income, debt service ability ratios to assess affordability, and appropriate loan-to-value ratios). Residential mortgages must be insured if their loan-to-value ratios are greater than eighty percent. Bank Act, S.C. 1991, c. 46, § 418(1) (Can.). Changes in 2010 and 2011 to mortgage insurance guidelines include a requirement that all borrowers meet standards for a five-year fixed rate mortgage even if they choose a mortgage with a lower interest rate and shorter term, reduce the maximum amortization period from thirty-five years to thirty years for new government-backed insured mortgages, and require a minimum down payment of twenty percent for government insurance on non-owner occupied properties purchased for speculation. Press Release, Dep't of Fin., Government of Canada Takes Action to Strengthen Housing Financing (Feb. 16, 2010) (Can.), available at [www.fin.gc.ca/n10/10-011-eng.asp](http://www.fin.gc.ca/n10/10-011-eng.asp); Press Release, Dep't of Fin., The Harper Government Takes Prudent Action to Support the Long-Term Stability of Canada's Housing Market (Jan. 17, 2011) (Can.), available at [www.fin.gc.ca/n11/11-003-eng.asp](http://www.fin.gc.ca/n11/11-003-eng.asp).

with a primary emphasis on supervisory reforms,<sup>2</sup> although product intervention remains a possibility.<sup>3</sup>

This article explores statutory and regulatory reforms to address market risks exposed in the current mortgage crisis. It presents a case study of divergent views of required reforms, enacted and proposed, in the United States and the United Kingdom, directed at the core concern of ensuring consumer protection and safe underwriting practices in the mortgage markets.

Such reforms are evaluated through the lens of behavioral influences on decision making by both consumers and industry actors. The academic literature has long documented behavioral influences on decision making, including influences that do not maximize an individual's expected utility.<sup>4</sup> As applied to the current mortgage crisis, studies have documented market characteristics, cognitive barriers, and behavioral limits and tendencies (collectively referred to as consumer barriers to self-protection) that prevent consumers from consistently exercising market discipline in screening unsafe mortgage products.<sup>5</sup> Few studies, however, have explored both the market characteristics and the cognitive barriers and behavioral limits and tendencies of industry actors that subvert consistent

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2. See CENT. BANK OF IRELAND, ENFORCEMENT STRATEGY 2011–2012 (2010), available at <https://www.centralbank.ie/regulation/processes/enforcement/Documents/Enforcement%20Strategy%202011-2012.pdf> (proposed enhancements in enforcement powers in the form of doubling of available penalties against individuals and regulated entities, suspensions and revocations of authorizations and restrictions on activities of regulated entities, as well increased staffing levels in the enforcement directorate).

3. See Press Release, Cent. Bank of Ireland, Review Identifies Concerns About Banks' First Time Buyer Mortgage Policies (July 21, 2010), available at <http://www.centralbank.ie/press-area/press-releases/Pages/ReviewIdentifiesConcernsaboutBanks%E2%80%99FirstTimeBuyerMortgagePolicies.aspx> (calling on lenders to evaluate whether they can do more to incorporate evaluations of customer suitability in the mortgage process, and indicating that if individual banks do not impose adequate safeguards, the Central Bank and Financial Regulator may impose loan to value ceilings, caps on loan to income multiples, income verification procedures, and limits on terms of new mortgages).

4. See, e.g., Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1476–81 (1998); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 43–56 (2000) [hereinafter Korobkin, *Behavioral Analysis and Legal Form*]; Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1075–1102 (2000).

5. See, e.g., Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007) (examining mortgage market characteristics); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 754–66 (2006) (examining studies of cognitive and behavioral limitations); see also DAVID DE MEZA, BERND IRLENBUSCH & DIANE REYNIERS, FINANCIAL CAPABILITY: A BEHAVIOURAL ECONOMICS PERSPECTIVE (2008) (a review of behavioral economics literature commissioned by Great Britain's Financial Services Authority). See generally, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008) (making a case for regulation of consumer credit by analogy with inspection and regulation regimes for physical consumer products).

industry efforts to ensure safe underwriting practices (collectively referred to as industry barriers to market discipline). In addition, until recently regulators have either failed to recognize such consumer and industry barriers, or failed to utilize them when formulating regulatory reforms in the mortgage markets. As a result, substantive legal requirements and regulatory policies have evolved, until recently, without consideration of this major influence on human decision making.

This article takes the position that these consumer and industry barriers must be fully recognized as we reshape the regulatory landscape governing mortgage market operations. It explores two issues: (1) the extent to which regulatory authorities have recognized barriers to market discipline so that regulatory policy might be shaped to reflect such barriers, and (2) how regulatory requirements and policies should be modified to achieve congruence with the legislative goals of product safety and consumer protection.

The global nature of the mortgage crisis has led government agencies in many countries to reconsider their regulatory policies.<sup>6</sup> This article examines proposed and enacted regulatory reforms in the United States and the United Kingdom. Regulatory authorities in both countries largely ignored consumer and industry barriers to market discipline until the outbreak of the mortgage crisis. In recent years, consumer barriers to self-protection have been explicitly recognized, and proposed regulatory reforms have attempted to effectively integrate this recognition into mortgage product reforms. Industry barriers to market discipline have also received recognition by some regulatory authorities, at least implicitly. However, in the United States regulatory reforms concerning supervisory intervention have failed to adequately recognize and address the significant and inherent barriers to market discipline on the part of industry actors.

Part II of this article explores product regulatory reforms in the United States and United Kingdom and analyzes whether such reforms adequately address consumer barriers to self-protection. This is part of the current debate over the need for a more rules-based regulatory system.<sup>7</sup> Part III explores reforms concerning supervisory intervention, primarily in the form of available sanctions and enforcement authority, and analyzes whether current reforms adequately address, in the long term, industry barriers to effective market discipline.

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6. See, e.g., FIN. SERVS. AUTH., *THE TURNER REVIEW* 53–103 (2009) [hereinafter *THE TURNER REVIEW*], available at [http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf); see also *supra* notes 1–3 and accompanying text. See generally FIN. CRISIS INQUIRY COMM’N, *THE FINANCIAL CRISIS INQUIRY REPORT* 52–66 (2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (describing the causal link between deregulation and the Great Recession).

7. See, e.g., Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Eric A. Posner, *Standards, Rules and Social Norms*, 21 HARV. J.L. & PUB. POL’Y 101 (1997); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985); Cass R. Sunstein, *Problems With Rules*, 83 CAL. L. REV. 953 (1995).

## II. CONSUMER BARRIERS TO SELF-PROTECTION

### A. Past Errors

Until the outbreak of the mortgage crisis, consumer barriers to self-protection received scant attention by regulatory authorities. On occasion, regulatory authorities noted the existence of offerings of mortgage products with characteristics that raised consumer protection concerns. However, possible market failure was deemed to be due to insufficient information or experience on the part of consumers. Defects in the market were not viewed as inherent or imbedded barriers to self-protection on the part of consumers. Thus, as early as 1999, U.S. federal banking regulators recognized that “[h]igher fees and interest rates [charged for subprime loans] combined with compensation incentives can foster predatory pricing or discriminatory ‘steering’ of borrowers to subprime products for reasons other than the borrower’s underlying credit worthiness.”<sup>8</sup> Two years later, federal regulators also recognized that some subprime lending practices “appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value.”<sup>9</sup> Examples noted were structuring a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged, inducing the borrower to refinance a loan repeatedly in order to charge high points and fees on each refinancing, and engaging in deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower. Regulators viewed the proper responses to these market risks to be modified or greater disclosure requirements and consumer education. Defects in the market were merely informational defects, not inherent or imbedded barriers to consumer self-protection.

In the United Kingdom, the Turner Review similarly noted the Financial Services Authority’s past reliance on market discipline on the part of consumers and industry actors. The agency was

reluctant to accept the idea that it should regulate products . . . .  
Its regulatory philosophy has been based on the assumptions  
that . . . product regulation is not required because well managed  
firms will not develop products which are excessively risky, and  
because well informed customers will only choose products  
which serve their needs.<sup>10</sup>

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8. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., INTERAGENCY GUIDANCE ON SUBPRIME LENDING 5 (1999), *available at* <http://www.federalreserve.gov/boarddocs/srletters/1999/sr9906a1.pdf>.

9. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 10 (2001) [hereinafter BD. OF GOVERNORS, EXPANDED GUIDANCE], *available at* <http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf>.

10. THE TURNER REVIEW, *supra* note 6, at 106.

Regulators in both the United Kingdom and the United States relied on disclosure to enable consumers to exercise market discipline.<sup>11</sup> Federal Reserve Chairman Ben Bernanke noted as late as 2007, that “effective disclosures should be the first line of defense against improper lending.”<sup>12</sup> Regulators also relied on consumer education to enable effective self-protection to occur.<sup>13</sup>

## **B. Recognition by Regulatory Authorities**

Studies over the past ten years confirmed that many consumers are unable to protect themselves in the mortgage market that emerged in this period. The Federal Reserve Board recognized this state of affairs when it modified real

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11. See *id.* at 87 (explaining that before the current crisis the FSA approach relied on transparency to ensure consumer protection); see also FIN. SERVS. AUTH., DP11/1, PRODUCT INTERVENTION 3 (2011) [hereinafter PRODUCT INTERVENTION] (“In the past the FSA’s regulatory approach was based on the assumption that effective consumer protection would be achieved provided sales processes were fair and product feature disclosure was transparent.”); FIN. SERVS. AUTH., DP 09/3, MORTGAGE MARKET REVIEW 72 (2009) [hereinafter MORTGAGE MARKET REVIEW] (“disclosure . . . was the cornerstone of our mortgage regime”); Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609, 58616–17 (Oct. 4, 2006) (final guidance); Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77249, 77255 (Dec. 29, 2005) (proposed guidance) (recognizing risks of payment option ARMs and interest-only mortgages for consumers and emphasizing communication with consumers to allow sound product decisions).

12. Ben S. Bernanke, Chairman, Fed. Reserve Bd. of Governors, Speech at the Federal Reserve Bank of Chicago’s 43d Annual Conference on Bank Structure and Competition: The Subprime Mortgage Market (May 17, 2007), *available at* <http://www.federalreserve.gov/newsevents/speech/Bernanke20070517a.htm> (noting that the Federal Reserve was now considering using its rulemaking power to possibly prohibit certain specific practices).

13. See, e.g., FIN. SERVS. AUTH., A NEW REGULATOR FOR THE NEW MILLENNIUM 7 (2000) (FSA will pursue improvements in financial literacy and improvements in information and advice available to consumers to address consumers’ lack of understanding of financial products offered); Edward M. Gramlich, Governor, Fed. Reserve Bd. of Governors, Remarks at the Federal Reserve Bank of Philadelphia Community and Consumer Affairs Conference: Subprime Lending, Predatory Lending (Dec. 6, 2000), *available at* <http://www.federalreserve.gov/boarddocs/speeches/2000/20001206.htm> (“the best defense against predatory lending is thorough knowledge on the part of consumers of their credit options and resources, [and a] massive educational campaign is needed to bring about this expanded consumer knowledge”); see also Edward M. Gramlich, Governor, Fed. Reserve Bd. of Governors, Remarks at the Fair Housing Council of New York: Predatory Lending (Apr. 14, 2000), *available at* <http://www.federalreserve.gov/boarddocs/speeches/2000/200004142.htm> (advocating expansion of borrower education programs, such as those provided by the Neighborhood Reinvestment Corporation, in order to address predatory lending issues).

estate lending regulations in July 2008.<sup>14</sup> The Federal Reserve Board recognized the existence of consumer barriers to self-protection in the mortgage market and, more importantly, that such barriers could not be adequately addressed through additional disclosures or financial education efforts. Barriers to market discipline were recognized as inherent in the nature of the current mortgage market and in consumer decision making. Similarly, the Financial Services Authority recognized that behavioral biases on the part of consumers have a significant impact on what can be achieved through disclosure, education, and counseling.<sup>15</sup> It therefore is considering greater product intervention.<sup>16</sup>

In the view of the Federal Reserve Board and the Financial Services Authority, the inability of consumers to protect themselves results from a combination of market characteristics and behavioral barriers. The factors identified are the following: (1) there is limited transparency, particularly in the market for subprime loans, which prevents comparison shopping; (2) innovative mortgage products are too complex to be understood and properly evaluated by consumers, a barrier exacerbated by inexperience; (3) these first two factors plus the cost of comparison shopping lead to limited shopping on the part of consumers; (4) in addition, persistent negative beliefs concerning credit availability and qualification (pessimism bias) prevent some consumers from shopping for more favorable terms; and (5) if consumers received more information on mortgage products they would still be unable to properly evaluate such information in part due to complexity, as previously noted, but also due to decision-making heuristics, including limited focus, that prevent proper consumer evaluations.<sup>17</sup>

The Federal Reserve Board summarized the limited transparency that characterizes the non-prime mortgage market. Rates can vary significantly based on the individual's risk profile and are usually obtainable only after application and payment of application fees.<sup>18</sup> The Financial Services Authority similarly found that it can be difficult for consumers to compare products, in part due to opaque charging structures.<sup>19</sup>

Complexity in the terms of innovative loan products is the second reason many consumers are unable to effectively protect themselves against unfair or unsafe products. The Federal Reserve Board concluded that most consumers either do not understand or cannot properly evaluate the terms and risks of nontraditional loan products, such as adjustable rate mortgages or payment option

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14. See *Truth in Lending*, 73 Fed. Reg. 44,522, 44,524–26 (July 30, 2008) (final rule).

15. See MORTGAGE MARKET REVIEW, *supra* note 11, at 72–75; see also FIN. SERVS. AUTH., DP08/5, CONSUMER RESPONSIBILITY 16 (2008) [hereinafter CONSUMER RESPONSIBILITY] (recognizing cognitive biases on the part of consumers).

16. PRODUCT INTERVENTION, *supra* note 11, at 23–28.

17. See *infra* notes 18–42 and accompanying text.

18. See *Truth in Lending*, *supra* note 14, at 44,524–25; see also McCoy, *supra* note 5, at 126–27.

19. PRODUCT INTERVENTION, *supra* note 11, at 24.

loans.<sup>20</sup> This is one form of complexity that undermines consumer self-protection. The U.S. Federal Trade Commission (FTC) had recognized complexity as a barrier to consumer self-protection as early as 2002.<sup>21</sup> This conclusion was reconfirmed by the FTC in 2007 in its study of both prime and subprime loans.<sup>22</sup>

Consumers' lack of understanding of complex loan products is exacerbated by a lack of experience and financial sophistication.<sup>23</sup> Mortgage loan transactions are infrequent transactions for most consumers, making comprehension of complex terms and risks more difficult.

Consumer self-protection in an unregulated market requires, at a minimum, comparison shopping. However, limited transparency and complexity prevent comparison shopping in the non-prime mortgage market. The U.S. Department of Housing and Urban Development embraced the view that complexity in non-prime mortgage products prevents consumer self-protection, relying in part on the analysis of Professor Jack Guttentag of The Wharton School. Professor Guttentag explained that limited, effective comparison shopping uncovered with respect to non-prime loans is due, in part, to market nichification.<sup>24</sup> This refers to the specialization of mortgage products and services based on a wide variety of borrower, property, loan, and documentation characteristics<sup>25</sup> making it difficult to determine comparative prices for the

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20. See Truth in Lending, *supra* note 14, at 44,524–25 (discussing difficulty in predicting changes in interest rates in adjustable rate mortgage loans).

21. DEP'T OF HOUS. & URBAN DEV., OFFICE OF POLICY DEV. & RESEARCH, RESPA: REGULATORY IMPACT ANALYSIS AND INITIAL REGULATORY FLEXIBILITY ANALYSIS, FR-5180-F-02, 2-39 to 2-40 (2008) [hereinafter RESPA], available at <http://www.hud.gov/offices/hsg/ramh/res/impactanalysis.pdf> (comments of the staff of the Bureau of Economics, the Bureau of Consumer Protection, and the Office of Policy Planning of the Federal Trade Commission, Oct. 28, 2002).

22. JAMES M. LACKO & JANIS K. PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES 27 (2007), available at <http://www.ftc.gov/be/workshops/mortgage/articles/lackopappalarado2007.pdf> (“Although most respondents understood many of the key features of their loans, many were either unaware of, did not understand, or misunderstood some important cost or feature of their loans. The misunderstandings involved loan features that had substantial impact on the overall cost of the loans, the future payments, or the ability to refinance . . .”). “Many of the respondents who said they understood the disclosures reported that had not been able to understand the disclosures on their own, but had relied on their originators or closing agents to explain them. . . . [Such reliance] can leave borrowers susceptible to incomplete explanations, [sic] and at worst, deceptive lenders.” *Id.* at 31.

23. See RESPA, *supra* note 21, at 2-100 (subprime borrowers are less knowledgeable about the mortgage process, making them more vulnerable to unfavorable mortgage outcomes); see also PRODUCT INTERVENTION, *supra* note 11, at 26 (complexity of financial products plus behavioral biases of consumers can result in misleading views about a product).

24. For a summary of Professor Guttentag's findings, see RESPA, *supra* note 21, at 2-37 to 2-38.

25. For a comparison of the current mortgage market and the earlier market, see McCoy, *supra* note 5, at 125–27 (describing the current market as risk-based pricing).

specific product a particular borrower is to receive. This is a second form of complexity, namely the non-uniform nature of pricing, and it also leads to a lack of transparency. An additional important barrier to comparison shopping is cost, since effective comparisons require additional applications and application fees, while delaying the receipt of funds.<sup>26</sup> The result is limited shopping. This creates a barrier to consumer self-protection that is inherent in market nichification, otherwise referred to as risk-based pricing.<sup>27</sup>

These three barriers to consumer self-protection—limited transparency, complexity, and limited shopping—were recognized by the Federal Reserve Board in 2008 and led to product intervention.<sup>28</sup> Additional barriers to consumer self-protection have been recognized by other U.S. federal agencies and quasi-governmental entities. They have also been recognized by the Financial Services Authority in the United Kingdom. These additional barriers to effective consumer self-protection involve borrowers' beliefs and decision-making strategies. One belief is that lenders are required by law to provide the best possible rate on loans. The Fannie Mae National Housing Survey found that more than forty percent of borrowers generally, almost two-thirds of African-American borrowers, and seventy-five percent of Spanish-speaking Hispanic borrowers did not know that this statement was false.<sup>29</sup> Another belief is that lenders or brokers will offer suitable products. The Financial Services Authority found that consumers assume that no firm will identify options that are not broadly appropriate for them.<sup>30</sup> This leads to limited comparison shopping or no comparison shopping.

A second belief is borrowers' pessimism concerning their credit quality. A Freddie Mac consumer credit survey found that thirty percent of white borrowers, approximately one-third of Latino borrowers, and approximately fifty percent of African-American borrowers who had good credit believed they had poor credit.<sup>31</sup> As a result, consumers will accept a subprime mortgage at a higher interest rate, carrying higher fees and a prepayment penalty, because they believe

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26. Truth in Lending, *supra* note 14, at 44,525 (footnotes omitted); *see also* McCoy, *supra* note 5, at 140–41 (fees and interest rates are disclosed after the consumer pays a nonrefundable application fee).

27. RESPA, *supra* note 21, at 2-38.

28. Truth in Lending, *supra* note 14, at 44,524–26.

29. FANNIE MAE, UNDERSTANDING AMERICA'S HOMEOWNERSHIP GAPS: 2003 FANNIE MAE NATIONAL HOUSING SURVEY 7 (2003), *available at* <http://www.fanniemae.com/global/pdf/media/survey/survey2003.pdf>.

30. FIN. SERVS. AUTH., CONSULTATION PAPER 10/28, MORTGAGE MARKET REVIEW: DISTRIBUTION AND DISCLOSURE 12 (2010) [hereinafter DISTRIBUTION AND DISCLOSURE], *available at* [http://www.fsa.gov.uk/pubs/cp/cp10\\_28.pdf](http://www.fsa.gov.uk/pubs/cp/cp10_28.pdf).

31. *See* Sheila D. Ards & Samuel L. Myers, Jr., *The Color of Money: Bad Credit, Wealth and Race*, 45 AM. BEHAV. SCIENTIST 223, 229 (2001) (citing Press Release, Freddie Mac (Sept. 2, 1999)); *see also* FIN. SERV. AUTH., THE FINANCIAL CONDUCT AUTHORITY: APPROACH TO REGULATION 24 (2011) [hereinafter APPROACH TO REGULATION] (stating there can be opportunities for firms to exploit consumer behavior such as lack of confidence or knowledge in retail markets).



they would not qualify for a prime mortgage or would not qualify for a non-prime mortgage with a lower interest rate and fee structure.

A third belief preventing consumer self-protection, by further undermining comparison shopping, is the belief among low-income borrowers and subprime borrowers that there are fewer options available to them, due either to a lack of lenders willing to make loans in their communities or to the lower quality of their creditworthiness.<sup>32</sup> This was a belief uncovered by both U.S. and U.K. regulatory authorities.<sup>33</sup> Pessimism concerning credit quality or availability of credit may be characterized as pessimism bias, the opposite of optimism bias that is displayed in most situations by most individuals. It is most prevalent among low-income and minority borrowers. All of these beliefs undermine self-protection by serving as barriers to comparison shopping.

A final barrier to consumer self-protection is the manner in which consumers make decisions in the mortgage market. There has been a great deal of research concerning decision-making heuristics, and Professor Lauren Willis has applied this research to decision making in the mortgage loan process.<sup>34</sup> Recently, regulators have recognized such behavioral limits to consumer self-protection. The regulators have recognized limited focus as a decision-making heuristic among consumers. The Federal Reserve Board noted:

Consumers considering obtaining a typically complex subprime mortgage loan may simplify their decision by focusing on a few attributes of the product or service that seem most important. A consumer may focus on loan attributes that have the most obvious and immediate consequence such as loan amount, down payment, initial monthly payment, initial interest rate, and up-front fees . . . . These consumers, therefore, may not focus on terms that may seem less immediately important to them such as future increases in payment amounts or interest rates, prepayment penalties, and negative amortization. They are also not likely to focus on underwriting practices such as income verification, and on features such as escrows for future tax and insurance obligations. Consumers who do not fully understand such terms and features, however, are less able to appreciate their risks, which can be significant. For example, the payment may increase sharply and a prepayment penalty may hinder the consumer from refinancing to avoid the payment increase.

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32. See RESPA, *supra* note 21, at 2-101 and 2-102 for a summary of the evidence.

33. FIN. SERVS. AUTH., MORTGAGE EFFECTIVENESS REVIEW: STAGE 2 REPORT 9–10 (2008), available at [http://www.fsa.gov.uk/pubs/other/MER2\\_report.pdf](http://www.fsa.gov.uk/pubs/other/MER2_report.pdf) (subprime consumers did not see traditional lenders as a realistic option).

34. See Willis, *supra* note 5, at 766–806.

Thus, consumers may unwittingly accept loans that they will have difficulty repaying.<sup>35</sup>

Similarly, the Financial Services Authority concluded that many consumers focus only on the short-term mortgage cost, and are therefore seduced by an attractive initial interest rate. This is true even among relatively sophisticated borrowers, who focused on the initial monthly payment.<sup>36</sup>

As a result of all of these consumer barriers to self-protection, regulatory modifications in the timing or manner of disclosures will *not* lead to effective self-protection. The U.S. General Accounting Office came to this conclusion as early as 2004, after discussions with federal officials and consumer advocates. It found that due to complexity in the terms of non-prime mortgages and borrowers' lack of financial education and sophistication, greater consumer education and even clear and transparent disclosures would be of limited effectiveness in decreasing the incidence of predatory lending practices.<sup>37</sup>

Chairman Bernanke of the Federal Reserve Board embraced the same conclusion more recently. He noted:

We have . . . learned from consumer testing . . . that not even the best disclosures are always adequate. According to our testing, some aspects of increasingly complex products simply cannot be adequately understood or evaluated by most consumers, no matter how clear the disclosure.<sup>38</sup>

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35. Truth in Lending, *supra* note 14, at 44,525–26 (footnotes omitted). Research on the part of the Federal Reserve staff has found, for example, that 40% of borrowers with income less than \$50,000—corresponding to the bottom half of the income distribution of ARM borrowers—are unaware of their per-period caps on their ARM mortgages, 53% are unaware of their lifetime cap, and 40% are unaware of the index of their ARM. By contrast, 13% of borrowers with income exceeding \$150,000—the top income decile of ARM borrowers—are unaware of their per-period caps, while 21% are unaware of their lifetime cap, and 8% are unaware of the index. BRIAN BUCKS & KAREN PENCE, DO HOMEOWNERS KNOW THEIR HOUSE VALUES AND MORTGAGE TERMS? 20, 30 tbl.5 (2006), available at <http://www.federalreserve.gov/pubs/feds/2006/200603/200603abs.html>.

36. See FIN. SERVS. AUTH., CONSULTATION PAPER 10/16, MORTGAGE MARKET REVIEW: RESPONSIBLE LENDING 57–58 (2010) [hereinafter RESPONSIBLE LENDING]; see also PRODUCT INTERVENTION, *supra* note 11 at 26 (consumers do not focus on costs that will arise later such as mortgage exit fees or mortgage arrears charges).

37. U.S. GEN. ACCOUNTING OFFICE, GAO 04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 94, 96 (2004), available at <http://www.gao.gov/new.items/d04280.pdf>. The evidence of lack of understanding of mortgage loan terms and products on the part of consumers is reviewed in Bar-Gill & Warren, *supra* note 5, at 27–30.

38. Ben S. Bernanke, Chairman, Fed. Reserve Bd., Address at the Federal Reserve System's Sixth Biennial Community Affairs Research Conference: Financial Innovation and Consumer Protection (Apr. 17, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>.

The Financial Services Authority expressed similar doubt that increased disclosure will change consumer behavior.<sup>39</sup> Indeed, additional disclosures may be counterproductive. As the Federal Reserve concluded:

Disclosures describing the multiplicity of features of a complex loan could help some consumers in the subprime market, but may not be sufficient to protect them against unfair loan terms or lending practices. Obtaining widespread consumer understanding of the many potentially significant features of a typical subprime product is a major challenge. If consumers do not have a certain minimum level understanding of the market and products, disclosures for complex and infrequent transactions may not effectively provide that minimum understanding. Moreover, even if all of a loan's features are disclosed clearly to consumers, they may continue to focus on a few features that appear most significant. Alternatively, disclosing all features may "overload" consumers and make it more difficult for them to discern which features are most important.<sup>40</sup>

In the United States, recognition of consumer barriers to self-protection, and the possible need for product intervention to address such barriers, was also found in the halls of Congress. Thus, the Dodd-Frank Act empowered the Consumer Financial Protection Bureau to issue regulations and take enforcement actions with respect to "abusive" acts or practices.<sup>41</sup> An abusive act or practice is one which:

- (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- (2) takes unreasonable advantage of—
  - (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product of service; or

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39. See MORTGAGE MARKET REVIEW, *supra* note 11, at 73–74.

40. Truth in Lending, *supra* note 14, at 44,526 (citation omitted); see also Willis, *supra* note 5, at 767 (discussing cognitive responses to information overload).

41. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 1031 (a)–(b) (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., 15 U.S.C., 18 U.S.C., 22 U.S.C., 31 U.S.C., 42 U.S.C.) [hereinafter Dodd-Frank Act].

- (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.<sup>42</sup>

## **C. Product Regulatory Reforms As a Response**

### **1. Legislative Goals**

The effectiveness of regulatory reforms must be judged in light of legislative goals embraced for the mortgage markets. In the United States, the Dodd-Frank Act reaffirmed the goal of effective consumer protection in mortgage market transactions. The importance of this goal was made clear by the creation of a Consumer Financial Protection Bureau.<sup>43</sup> The Dodd-Frank Act also reaffirmed the goal of banking industry safety, in part by ensuring product safety in the mortgage markets. In the United Kingdom, the Financial Services and Markets Act 2000 had reaffirmed the goal of consumer protection.<sup>44</sup> The Financial Services Act 2010 did not modify that objective. The importance of that objective was evidenced by provisions that sought to better accomplish it. Thus, the Act embraced the goal of enhanced consumer financial knowledge through financial education<sup>45</sup> and established a Consumer Financial Education Body to accomplish that goal. It also put in place regulatory authority to write rules and implement measures to ensure consumer redress in cases of widespread or regular failure to comply with regulatory requirements.<sup>46</sup> At the same time the goal of stability of the financial system was reaffirmed.<sup>47</sup>

The emphasis on enhanced consumer education is one small point of departure when comparing regulatory reforms in the United Kingdom and the United States. The main focus in the Dodd-Frank Act was on product intervention to accomplish enhanced consumer protection. Disclosure requirements were to be simplified and modified to assist consumers in the proper choice of mortgage products.<sup>48</sup> However, this was not the primary focus of statutory modifications. In the United Kingdom, financial education was one of two new objectives in the 2010 amendments to the Financial Services and Markets Act 2000 along with

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42. *Id.* § 1031(d), 12 U.S.C. § 5531(d) (2010).

43. *See id.* § 1021(a)–(b), 12 U.S.C. § 5511(a)–(b) (2010) (Consumer Financial Protection Bureau must ensure markets for consumer financial products and services are fair, transparent and competitive and consumers are protected from unfair, deceptive, or abusive acts and practices).

44. Financial Services and Markets Act, 2000, c. 8, § 2(2)(c) (U.K.).

45. Financial Services Act, 2010, c. 28, § 2 (U.K.). The Consumer Financial Education Body has since become the Money Advice Service.

46. *Id.* § 14.

47. *Id.* § 1.

48. Dodd-Frank Act, § 1021(b), 12 U.S.C. § 5511(b) (consumers are to be provided timely and understandable information to make decisions about financial transactions).

financial stability.<sup>49</sup> Moreover, the FSA has continued to emphasize that consumers must take responsibility for their decisions.<sup>50</sup> Moving forward, the challenge is to develop and implement regulatory reforms that will best serve the twin goals of consumer protection and banking industry safety (stability).

## **2. Product Regulatory Reforms**

In light of inherent or imbedded consumer barriers to self-protection, how should the mortgage market regulatory regime be modified to ensure adequate consumer protection? One form of response is product regulatory reforms. This response substitutes government intervention for consumer and industry market discipline to prohibit, restrict or modify abusive mortgage products and practices. The issue is what is the most effective form of government intervention? The debate regarding product intervention has become a debate over the benefits of rules-based or principles-based regulations. In the United States, regulatory reforms can be characterized as a movement toward a more rules-based regulatory regime. In the United Kingdom regulatory reforms have continued to rely on a more principles-based regulatory regime.

These reforms are in their formative stage. Standards have been proposed in both the United States and the United Kingdom to implement statutory requirements and revised regulatory viewpoints. This subsection of the article examines the proposed regulatory standards. The next subsection evaluates whether they are more likely to lead to robust consumer protection and product safety than the standards employed during the last decade.

The movement toward a more rules-based regulatory regime in response to the mortgage crisis is evidenced by the Dodd-Frank Act. The new statutory requirements, and proposed regulatory requirements, take the form of product intervention. The Dodd-Frank Act eliminated no-documentation loans by imposing a requirement that creditors verify the income or assets they rely upon to underwrite mortgage loans.<sup>51</sup> The Act also addressed the repayment risks posed by innovative loan products. Under the Act, no creditor may make residential mortgage a loan unless the creditor “makes a reasonable and good faith determination . . . that . . . the consumer has a reasonable ability to repay the loan.”<sup>52</sup> In addition, creditor determinations regarding borrowers’ ability to repay were constrained for all non-standard loans, i.e. loans that are not fixed rate, self-amortizing loans.<sup>53</sup> Creditors must determine ability to repay based on (a) a fully-amortizing repayment schedule, (b) the fully-indexed interest rate, and (c)

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49. Financial Services Act, 2010, c. 28, 1–2 (U.K.).

50. See CONSUMER RESPONSIBILITY, *supra* note 15, at 7–8; see also APPROACH TO REGULATION, *supra* note 31, at 15 (FCA must have regard to six regulatory principles, including the principle that consumers should take responsibility for their decisions).

51. Dodd-Frank Act, § 1411(a)(1), 15 U.S.C. § 1639c(a)(1) (West, Westlaw 2012).

52. *Id.*

53. *Id.* § 1411(a)(6), 15 U.S.C. § 1639c(a)(6) (West, Westlaw 2012).

combined payments for all mortgage loans secured by the same dwelling and made to the same consumer.<sup>54</sup>

The Federal Reserve Board has proposed regulations to implement the Act's new underwriting requirements. Some of the regulations contain additional, detailed requirements. However, many of these detailed requirements for determinations of consumers' ability to repay are not mandatory for all consumer mortgage loans. One set of regulations implements the Dodd-Frank minimum underwriting requirements found in section 1411 of the Act, and applies to all residential mortgage loans. The proposed rule merely repeats the list of factors contained in the statute and states "a creditor must consider" such factors, among others, in underwriting decisions.<sup>55</sup>

A second set of regulations applies to "qualified mortgages," a new category of loan product that the Dodd-Frank Act grants a presumption of compliance with the Act's minimum underwriting requirements, including determinations of "ability to repay."<sup>56</sup> The proposed regulations contain two underwriting alternatives for meeting the definition of a "qualified mortgage."<sup>57</sup> A safe harbor is provided if the underwriter "considers and verifies the consumer's current or reasonably expected income or assets" in determining repayment ability. This alternative excludes other bases for determination such as credit history. However, the proposal does not require the creditor to base underwriting decisions on any particular debt-to-income ratio or remaining income after subtracting monthly debt obligations. The other alternative for meeting the definition of "qualified mortgages" provides a presumption of compliance, as opposed to a safe harbor. This alternative merely repeats the various underwriting factors a creditor must "consider" for all mortgages.<sup>58</sup> It does not require underwriting to be based on a borrower's income.

A third set of regulations imposes requirements for "qualified residential mortgages," another new category of loan product recognized in the Act that does not require a five percent risk retention otherwise imposed in the event of mortgage securitizations.<sup>59</sup> These are the most detailed of the proposed regulations. They require, *inter alia*, a maximum loan-to-value ratio of 80% for purchase mortgage transactions, 75% on rate and term refinance loans, and 70% for "cash out" refinancings.<sup>60</sup> They also require a debt-to-income ratio of no more than 28% for mortgage-related debt payments and 36% for total debt payments.<sup>61</sup>

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54. *Id.* § 1411(a)(2), (3), (6), 15 U.S.C. § 1639c(a)(2), (3), (6) (West, Westlaw 2012).

55. Regulation Z; Truth in Lending, 76 Fed. Reg. 27,390, 27,483 (proposed May 11, 2011), codified at 12 C.F.R. pt. 226.43(c)(2) (effective Jan. 18, 2014) [hereinafter Regulation Z].

56. Dodd-Frank Act, § 1412, 15 U.S.C. 1639c(b) (2012).

57. Regulation Z, *supra* note 55, at 27,484.

58. *Id.* at 27484–85.

59. Dodd-Frank Act, § 941(b), (c), (e), 15 U.S.C. § 78o-11(b), (c), (e) (West, Westlaw 2012).

60. Credit Risk Retention, 76 Fed. Reg. 24,090, 24,166–67 (proposed Apr. 29, 2011) (to be codified at 12 C.F.R. pts. 43, 244, 373, 1234; 17 C.F.R. pt. 246; 24 C.F.R. pt. 267).

61. *Id.* at 24,166.

These very detailed requirements are not, however, mandatory for all consumer mortgage loans. Rather, they are imposed only for those loans for which five percent risk retention will not be required in the event of securitization.

In contrast, product reforms embraced or proposed in the United Kingdom continue to rely primarily on a principles-based regulatory regime,<sup>62</sup> although there are two more detailed proposals that are rules-based. One proposal is a specific prohibition against self-certification loans.<sup>63</sup> A second proposal is a clarification that lenders, not intermediaries, must assess whether the mortgage product is “affordable” for the consumer.<sup>64</sup> To determine “affordability” the FSA has proposed that lenders assess the consumers’ ability to repay based on their net income, committed expenditures and basic essential expenditures and basic quality of living costs.<sup>65</sup> In addition, when determining maximum borrowing capacity for purposes of affordability, calculations must be on a capital and interest (self-amortizing) basis, and factor in possible rate increases.<sup>66</sup>

Apart from these two changes, the additional requirements imposed and proposed may properly be characterized as a continued reliance on principles-based regulations. Thus, it is proposed that the “seller” of a mortgage product must be required to act in the client’s “best interest.”<sup>67</sup> This would replace the current requirement that the firm recommend “the most suitable” product from all those available to the firm, but only in advised sales. The FSA Handbook, as revised in 2009, requires that a lender not impose “excessive” charges in mortgage loans.<sup>68</sup> In addition, one regulation not altered is the requirement that mortgage brokers “pay due regard to the interests of its customers and treat them fairly.”<sup>69</sup>

### **3. A Preliminary Evaluation Based on Legislative Congruence**

Arguably rules-based regulatory regimes address consumer barriers to self-protection—both market imperfections and cognitive and behavioral imperfections that inherently prevent market discipline. Product interventions

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62. FIN. SERV. AUTH., THE 2009 ENFORCEMENT GUIDE 9 (2009) [hereinafter THE ENFORCEMENT GUIDE] (explaining that the FSA believes a more principles-based approach will allow it to achieve regulatory objectives in a more efficient and effective way).

63. RESPONSIBLE LENDING, *supra* note 36, at 16, 18–19 (2010); FIN. SERV. AUTH., CONSULTATION PAPER 11/31, MORTGAGE MARKET REVIEW: PROPOSED PACKAGE OF REFORMS 67, 78 (2011) [hereinafter PROPOSED PACKAGE OF REFORMS].

64. DISTRIBUTION AND DISCLOSURE, *supra* note 30, at 14; PROPOSED PACKAGE OF REFORMS, *supra* note 63, at 27, 148.

65. PROPOSED PACKAGE OF REFORMS, *supra* note 63, at 84.

66. *Id.* at 122; RESPONSIBLE LENDING, *supra* note 36, at 24.

67. DISTRIBUTION AND DISCLOSURE, *supra* note 30, at 16.

68. FIN. SERVS. AUTH., MORTGAGES: CONDUCT OF BUSINESS 12.2.1, 12.5 (2012), available at <http://fsahandbook.info/FSA/html/handbook/MCOB/12> (select the hyperlink to the desired chapter section).

69. FIN. SERVS. AUTH., KEY RULES FOR MORTGAGE AND HOME REVERSION BROKERS 6, princ. 6 (2008), available at [http://www.fsa.gov.uk/pubs/handbook/keyrules\\_mhr.pdf](http://www.fsa.gov.uk/pubs/handbook/keyrules_mhr.pdf).

prohibit or restrict risky mortgage loans in substitution for reliance on market discipline to accomplish this outcome. Rules-based regulations that clearly impose specific mandates are more likely to lead to industry compliance (a) as long as industry decisions are being made within the parameters clearly subject to the regulations in question, and (b) as long as the mandates are vigorously enforced. For example, a requirement that no mortgage loan (a) can exceed a loan-to-value ratio of ninety percent, calculated based on combined first and subsequent liens, and (b) can be made to a borrower with a debt-to-income ratio that exceeds twenty-eight percent based on all mortgage indebtedness and thirty-six percent based on total indebtedness, would serve, to a significant degree, the legislative purpose of ensuring mortgage loans are safe for both the lender and borrower. The specified parameter is broad enough to cover all mortgage loans, and the required underwriting criteria are specific enough to make noncompliance apparent. Indeed, this was the regulatory regime in the United States prior to 1982. Commentators have debated the relative advantages of each regime for achieving compliance with legal requirements and legislative policies.<sup>70</sup> The criticism of a rules-based regulatory regime is that it can lead to “creative compliance”—technical compliance in a manner that disserves legislative purposes. This is a weakness recognized by the Financial Services Authority.<sup>71</sup> The proposed reforms in the United States are subject to this criticism.

The weakness in the U.S. movement toward a more rules-based regulatory regime for mortgage underwriting is the lack of specificity in the criteria lenders must utilize to determine “ability to repay.” The Dodd-Frank Act

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70. Some commentators have argued that the nature of principles-based regulations make them less likely to be evaded through technical or creative compliance, and that the unpredictable liability they impose cause industry actors to proceed more cautiously. See Julia Black, Martyn Hopper & Christa Band, *Making a Success of Principles-Based Regulation*, 1 L. & FIN. MKTS. REV. 191, 193 (2007); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1695–96 (1976); Steven L. Schwarcz, *The “Principles” Paradox*, 10 EUR. BUS. ORG. L. REV. 175, 179–80 (2009) (discussing the academic literature). Other commentators have argued that the greater precision in rules-based regulations encourage greater compliance, in part due to ease of application and enforcement. See Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L. J. 65, 72–73 (1983) (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); Ehrlich & Posner, *supra* note 7, at 262; Korobkin, *Behavioral Analysis and Legal Form*, *supra* note 4, at 56–57 (rules are more likely to be over- and under-inclusive but more likely to have a dynamic effect on social norms by encouraging people to behave in a socially desirable way); Frederick Schauer, *The Tyranny of Choice and the Rulification of Standards*, 14 J. CONTEMP. LEGAL ISSUES 803, 803–804 (rules discourage socially undesirable activities and encourage socially desirable ones).

71. See, e.g., FIN. SERVS. AUTH., PRINCIPLES-BASED REGULATION: FOCUSING ON THE OUTCOMES THAT MATTER 6 (2007), available at <http://www.fsa.gov.uk/pubs/other/principles.pdf> [hereinafter PRINCIPLES-BASED REGULATION] (observing that highly complex rules can divert attention towards adhering to the letter, rather than the purpose, of regulatory standards).



merely states determinations shall *include* consideration of seven possible factors.<sup>72</sup> Current income and debt-to-income ratio or residual income are listed as factors, but determinations are not required to be made on that basis. Other possible criteria include credit history and expected income. Indeed, the list of factors to be considered is not exclusive. Thus, another round of risky mortgage loans, where underwriters ignore borrower's current income and residual income in their underwriting decisions, is possible if lenders are motivated by profit pressures to creatively comply.

In addition, the 2011 proposed regulatory standards in the United States that implement the minimum mortgage underwriting requirements in the Dodd-Frank Act impose no maximum loan-to-value ratio, and no specific debt-to-income ratio or maximum residual income requirement. Specific limits are proposed only for "qualified residential mortgages." However, even these limits are not applicable for sales to and securitizations by FNMA and Freddie Mac, as long as they are subject to federal conservatorship. This is the first loophole that can be exploited to avoid specified underwriting requirements for qualified residential mortgages. The second loophole that can be exploited is a decision to either (a) underwrite loans to be held in portfolio, rather than securitized, or (b) securitize loans but retain a required five percent interest. In either case, the specified underwriting requirements for "qualified residential mortgages," which include specified limits on loan-to-value, debt-to-income and residual income, are completely avoided. Indeed, the U.S. regulators have opined that a relatively small portion of future mortgage loans in the United States are expected to comply with the proposed "qualified residential mortgage" requirements.<sup>73</sup>

This leaves only the minimum underwriting requirements imposed for all mortgages, as well as those for "qualified mortgages." However, none of these proposed regulations (a) mandate that "ability to repay" *must* be based on current income or assets, and (b) impose any quantitative requirements or limits when underwriting decisions *are* based on borrower's income or assets. In effect, due to creative compliance we may revert to the same regulatory position that existed prior to and led to the mortgage crisis, i.e. reliance primarily on market discipline. Industry members that creatively comply would be faced only with a general standard that they must make a "reasonable and good faith determination" of a borrower's "ability to repay." This is not a mandate that is significantly different, in form, than the earlier mandate that underwriting policies and decisions must be "prudent" and loan products must be "safe and sound."<sup>74</sup> In such an environment the key to effective consumer protection is going to be supervisory intervention—the extent to which regulators criticize industry underwriting decisions and deter risky products and practices through sustained enforcement efforts that impose

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72. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, §1411(a)(3), 15 U.S.C. § 1639c(a)(3).

73. Floyd Norris, *A Flaw in New Rules for Lending*, N.Y. TIMES, Apr. 1, 2011, at B1 (FDIC chair Sheila Bair expects qualified residential mortgages will be a small part of the market and other loans will be made by lenders who have "skin in the game").

74. Real Estate Lending Standards, 12 C.F.R. § 365.2 (2010).

penalties substantial enough to deter excessive risk. This is further examined in Part Three of this article.

Turning to the primarily principles-based regulatory regime that continues to be favored in the United Kingdom, the regulatory viewpoint during the last decade, in both the United Kingdom and the United States, was that principles-based standards were more likely to lead to legal compliance and congruence with the legislative purpose of consumer protection.<sup>75</sup> However, the underwriting decisions made in both the United States and United Kingdom during the last decade have shaken confidence in this viewpoint.

The weakness of a principles-based regime is that it opens the door to “creative noncompliance” by industry actors, by means of which almost any underwriting product or practice can be seen as compliant with a general regulatory principle. For example, payment option, adjustable rate mortgages, which eventually led to payment shock and borrowers’ inability to repay, could be viewed by industry actors in the United States, at the time the loans were made, as “prudent” or “safe” products. The justification for this conclusion would be that it was expected the borrower could always refinance the loan when it became unaffordable, or sell the home at a profit due to constantly rising real estate values. The risks of the product can be ignored through reliance on rosy predictions, and an overly general standard would allow such assessments.

Thus, principles-based regulations in the United States did not stop Countrywide from underwriting a significant number of no-documentation and limited-documentation loans, as well as payment option ARMs.<sup>76</sup> Nor did they stop Washington Mutual from underwriting a significant number of stated-income mortgage loans.<sup>77</sup> Indeed, between forty-four and fifty-two percent of all payment option ARMs originated in the United States in 2005–2007 were originated by U.S. banks, thrifts or their affiliates.<sup>78</sup>

The same conclusion could be drawn from the regulations in effect in the United Kingdom, which required, inter alia, that a mortgage loan be “affordable” as well as “suitable” for the borrower. This did not prevent a market in which almost half of the home loans made in the United Kingdom between 2007 and the start of 2010 did not require proof of income.<sup>79</sup> The FSA’s proposals eliminate

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75. See PRINCIPLES-BASED REGULATION, *supra* note 71, at 7.

76. See Ruth Simon & James R. Haggerty, *Countrywide’s New Scare: “Option ARM” Delinquencies Bleed into Profitable Prime Mortgages*, WALL ST. J., Oct. 24, 2007, at C1.

77. OFFICES OF INSPECTOR GEN., DEP’T OF TREASURY, FED. DEPOSIT INS. CORP., REPORT NO. EVAL-10-002, EVALUATION OF FEDERAL OVERSIGHT OF WASHINGTON MUTUAL BANK 10 (2010) [hereinafter EVALUATION OF FEDERAL OVERSIGHT], available at <http://fdicoig.gov/reports10%5C10-002EV.pdf>.

78. Vincent Di Lorenzo, *Principles-Based Regulation and Legislative Congruence*, 15 N.Y.U. J. LEGIS. & PUB. POL’Y 45, 69 (2012) [hereinafter Di Lorenzo, *Principles Based Regulation*] (providing calculations for fourth quarter 2005 through second quarter 2007).

79. Sharlene Goff & Brooke Masters, *FSA Looks to Impose Checks for Mortgages*, FIN. TIMES, July 13, 2010, available at <http://www.ft.com/intl/cms/s/0/cb948a7e-8e4f-11df-964e-00144feab49a.html#axzz2BHqfWpqF>.

self-certification or no-verification loans, and require affordability to be based on the income and the committed and basic expenditures of the borrower. This is more specific than the proposed regulations issued by the Federal Reserve Board. Nonetheless, there is no additional regulatory detail regarding affordability—no maximum debt-to-income ratio or loan-to-value ratio.<sup>80</sup> Thus, the ultimate determination of affordability lies with bank management. Indeed, the FSA noted that while lenders must take full account of borrower income and expenditures and be able to demonstrate a loan is affordable, the FSA’s proposed regulatory standard gives “lenders the freedom to decide how they will calculate this.”<sup>81</sup>

As is true with the issue of “creative compliance” in a rules-based regulatory regime, “creative noncompliance” in a principles-based regulatory regime must also be addressed through supervisory intervention—sustained regulatory enforcement efforts that impose penalties substantial enough to deter excessive risk. This becomes the most important determinant of effective consumer protection, as well as long-term industry safety or stability. Supervisory intervention is further explored in Part Three of this article.

### III. INDUSTRY BEHAVIOR AND REGULATORY RESPONSES

Part III addresses the issue of compliance with regulatory requirements—whether principles-based or rules-based. In the period prior to the mortgage crisis, regulatory authorities relied on industry actors to exercise self-discipline to ensure they were underwriting safe mortgage products—safe for the consumer and safe for the industry. When industry self-discipline was lacking in a particular firm, regulators in both the United States and United Kingdom exercised a light-touch approach to enforcement efforts. This light-touch supervisory approach ignored current business models that did not deem legal compliance to be an unquestioned obligation, certainly not an absolute obligation to seek a maximum level of compliance with regulatory requirements and related statutory objectives. The prevalent business model in the financial services industry had become one that sought to maximize short-term profits. To achieve this goal, industry actors sought to *evade* legal compliance if that response maximized short-term profits. At times, *noncompliance* was deemed to be an acceptable method of operation to achieve the goal of maximizing short-term profits. In other words, decision making based on cost-benefit evaluations was applied by industry actors to the issue of legal compliance. In such an environment, the prevalence and severity of enforcement efforts is the key to altering industry cost-benefit evaluations in favor of robust compliance. However, a light-touch approach to enforcement created the opposite incentive.

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80. PROPOSED PACKAGE OF REFORMS, *supra* note 63 at 57, 59; RESPONSIBLE LENDING, *supra* note 36, at 42.

81. PROPOSED PACKAGE OF REFORMS, *supra* note 63, at 83.

## **A. Past Errors**

### **1. Embrace of Market Discipline**

In the period prior to the current mortgage crisis, the accepted regulatory viewpoint was that market discipline by industry actors would constrain excess risk taking on the part of lenders. The Turner Review summarized the FSA's regulatory and supervisory approach before the current crisis in these terms:

The primary responsibility for managing risks lies with the senior management and boards of the individual firms, who are better placed to assess business model risk than bank regulators, and who can be relied on to make appropriate decisions about the balance between risk and return . . . .<sup>82</sup>

Banking regulators in the United States shared the same viewpoint. As early as 1983, the Comptroller of the Currency noted its belief that "aside from regulations, factors such as market forces and management philosophies are the *real* determinants of banks' real estate lending practices."<sup>83</sup> Based on this viewpoint, primary responsibility for compliance with legal requirements, such as a mandate of "safe and sound" operations, was delegated to bank management.<sup>84</sup> In the United States this remained the case even after the savings and loan crisis uncovered very risky lending operations and policies.<sup>85</sup>

### **2. Underlying Assumptions**

The embrace of market discipline as an effective regulator of business conduct in the mortgage markets was based on several assumptions. First, regulators assumed that lenders are subject to market risks from underwriting unsafe products. Second, regulators assumed that the primary contact point for the consumer would be the lender (loan originator). These assumptions did reflect market realities in the 1980s or first-half of the 1990s. However, in the last ten to fifteen years market realities have altered dramatically.<sup>86</sup> Third, regulators assumed that lenders' actions are influenced by assessments of long-term risks, and benefits, as much as they are influenced by short-term benefits and risks. The

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82. THE TURNER REVIEW, *supra* note 6, at 87.

83. Real Estate Lending by National Banks, 48 Fed. Reg. 40,698, 40,699 (Sept. 9, 1983) (emphasis added).

84. *Id.* at 40,699–700.

85. Real Estate Lending Standards, 57 Fed. Reg. 62,890, 62,893 (Dec. 31, 1992) (observing that regulators rely on institutions to establish and maintain internal real estate lending policies, consistent with safe and sound operation and Interagency Guidelines for Real Estate Lending).

86. *See infra* notes 90–96 and accompanying text.

actions of lenders that led to the current mortgage crisis demonstrated that this assumption was false for many lenders. For many, the current business model was one that focused on short-term profits. In addition, psychological studies that raised concerns regarding the proper assessments of risks by the general public, should have raised similar concerns regarding risk assessment by industry actors.<sup>87</sup> These first three assumptions underlay a belief that market discipline would successfully serve the legislative goal of safety.

A reliance on industry market discipline to serve the legislative goal of consumer protection required additional assumptions. First, it was assumed that safe products from the standpoint of the lender are similarly safe products from the standpoint of the consumer. Second, when this was not the case then consumer market discipline was assumed to serve as an effective regulator. The first of these assumptions was true in the standardized mortgage market of an earlier decade. However, the nichification of the mortgage market and the introduction of risk-based pricing, discussed in Part Two, nullified this assumption for some product markets.<sup>88</sup> A loan could be “safe” for the lender yet abusive from the standpoint of the consumer because the consumer was overcharged via higher interest rates, higher fees, or higher prepayment penalties not justified by underwriting costs or credit risks.<sup>89</sup> The second of these assumptions was proven false due to consumer barriers to market discipline, as discussed in Part Two of this article.

## **B. Regulators’ Recognition of Adverse Market Incentives**

The current mortgage industry realities identified above, that undermine assumptions regarding market discipline, are in part market realities and in part behavioral realities. The changed market realities are the originate-to-sell business model, the use of loan intermediaries, and the short-term profit business model of operation. The behavioral reality is the poor assessment of long-term risk by industry actors. These realities have been documented in public policy papers. My concern in this article is, however, with the timing and the extent of recognition by regulatory agencies as well as legislative bodies. Such recognition would be a prerequisite to changes in regulatory policy. This section of the article examines regulatory recognition of altered market realities. The next section explores regulatory recognition of behavioral barriers to proper risk assessment by industry actors. The final section of this article explores how regulatory policy in the United States and the United Kingdom has been changed to reflect such realities.

Three developments in the mortgage markets that significantly affect risk assessments have been recognized by regulators in recent years. The first is the originate-to-distribute model of loan originations. The Federal Reserve Board,

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87. See *infra* notes 103–107 and accompanying text.

88. See *supra* notes 24–27 and accompanying text.

89. See Di Lorenzo, *Principles-Based Regulation*, *supra* note 78, at 78–84.

and other federal financial regulators, have recognized this business model in recent regulatory releases, noting that as a consequence “lenders often [did] not expect . . . to bear the credit risk of borrower default.”<sup>90</sup> In the United States this method of operation was in fact inescapable with the rise of independent mortgage companies, since such firms do not hold portfolios of loans long-term. The Turner Review noted that the significant increase in securitizations of residential mortgages was not limited to the United States but characterized the U.K. market as well through 2007.<sup>91</sup>

A second market development that provided an adverse incentive to safety in risk assessments was the increasing reliance on mortgage brokers to serve as the point of contact with borrowers. In 2008, the Federal Reserve recognized that sixty percent or more of residential mortgages originated in the last several years were originated through a mortgage broker.<sup>92</sup> Similarly, the Financial Services Authority noted that intermediaries “originated” thirty-five percent of mortgages in 2000 but that figure had grown to sixty percent in 2007–2008.<sup>93</sup>

The originate-to-distribute business model minimized market discipline in the origination process. The reliance on mortgage brokers further undermined the possibility of market discipline on the part of consumers that might constrain both unsafe and unfair products. As discussed in Part Two, barriers to self-protection prevented many consumers from exercising market discipline directly. Thus, they relied on brokers to serve their interests. However, broker compensation was maximized by maximizing loan volume, interest rates and origination fees. Higher risk products, such as payment option loans, carried higher interest rates and fees. There was little incentive to steer consumers to lower risk or more affordable loan products.

These two market realities undercut the assumption that self-interest would lead industry actors to avoid or correct unsafe mortgage products—unsafe from the perspective of the entity holding the loan as well as the borrower. Market realities also undermined any assumption that self-interest would lead industry actors to avoid or correct unfair mortgage products—products imposing high interest rates or fees not justified by credit risk. Indeed, industry self-interest would induce rather than constrain the spread of unfair products.

A third market reality that has influenced long-term risk assessment by industry actors is a business model that emphasizes short-term profits. Commentators, and regulators in recent years, have recognized that this is the business model shaping decisions among many members of the financial services

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90. Credit Risk Retention, *supra* note 60, at 24094–95 (noting the 75% increase in annual residential mortgage backed securitizations between 2002 and 2004, and 150% increase between 2002 and 2005 and 2006); *see also* Truth in Lending, *supra* note 14, at 44526.

91. THE TURNER REVIEW, *supra* note 6, at 14.

92. Truth in Lending, *supra* note 14, at 44525.

93. DISTRIBUTION AND DISCLOSURE, *supra* note 30, at 9.

industry.<sup>94</sup> This market reality placed a premium on larger fees generated by (a) more innovative and higher-risk mortgage products and (b) unfair mortgage terms. It also had a significant influence on cost-benefit evaluations of risks of noncompliance with legal mandates, which is further discussed below.

In response to these adverse market incentives some direct intervention in industry practices have been enacted in the last year. The Dodd-Frank Act prohibits mortgage broker compensation that varies based on the terms of the loans,<sup>95</sup> an example of the U.S. movement toward a more rules-based regulatory regime. In addition, the Dodd-Frank Act requires five percent risk retention by originators for loans that are securitized, unless such loans meet the safe underwriting features that define “qualified residential mortgages,”<sup>96</sup> as discussed in Part Two of this article.

How effective such direct interventions will be depends on industry motivations, based on assessments of risks versus benefits, that is, motivations actually to serve legislative purposes, or to creatively comply.

### **C. Regulators’ Inattention to Industry Behavioral Barriers?**

Regulators have recently recognized both the market realities and behavioral barriers that prevent market discipline on the part of consumers. Regulators have also recognized the market realities that in fact provide disincentives to industry actors in meeting the legislative goals of safety and fairness in mortgage products and practices. Regulators have not, however, explicitly recognized behavioral barriers to proper risk assessment on the part of industry actors—proper risk assessment that would be more likely to lead to legislative congruence.

#### **1. Influences on Industry Compliance Decisions**

Studies of organizational behavior involving legal compliance have uncovered various influences on corporate decision making.<sup>97</sup> The debate that emerges from such studies concerns the influence of legal sanctions. Studies and

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94. Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 CRITICAL REV. 195, 206 (2009), available at [http://www.cepr.org/meets/wkcn/1/1716/papers/Acharya\\_Richardson\\_CriticalReviewArticle.pdf](http://www.cepr.org/meets/wkcn/1/1716/papers/Acharya_Richardson_CriticalReviewArticle.pdf).

95. See Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, § 1403, 15 U.S.C. § 1639b (2012); see also Truth in Lending, 75 Fed. Reg. 58,509, 58,509 (Sept. 24, 2010) (effective Apr. 6, 2011).

96. See Dodd-Frank Act, § 941(b), 15 U.S.C. § 78o-11(b) (2012); see also Credit Risk Retention, *supra* note 60, at 24,090.

97. See Vincent Di Lorenzo, *Does the Law Encourage Unethical Conduct in the Securities Industry?*, 11 FORDHAM J. CORP. FIN. L. 765, 771 (2006) [hereinafter Di Lorenzo, *Does the Law Encourage Unethical Conduct*] (summarizing studies and perceived influences on corporate behavior).

commentators in the period preceding the current decade offered a difference of opinion on the significance of legal sanctions in influencing corporate decisions.<sup>98</sup> However, more recent studies have documented the substantial influence of the frequency and severity of sanctions.<sup>99</sup> This is particularly true in the financial services industry—the subject of most of the recent studies and commentary.<sup>100</sup>

There are several related reasons for the conclusion of substantial influence. First, industry decisions, including decisions on legal compliance, are based on cost-benefit evaluations. Frequently, legal mandates are strictly followed or creatively ignored on the basis of an evaluation of benefits of compliance against risks of noncompliance.<sup>101</sup> In other words, robust legal compliance occurs on the basis of a highly-circumstantial determination made by industry actors in particular contexts. Second, a very important influence on all business decisions is the goal of short-term profits. Third, behavioral heuristics and tendencies affect industry actors as much as they affect the general public. These behavioral characteristics can skew cost-benefit evaluations in favor of “creative compliance,” “creative noncompliance,” or, at times, in favor of violation of clear legal mandates.<sup>102</sup>

Behavioral barriers to effective risk assessment among industry actors have been the subject of study far less frequently than behavioral barriers among consumers. However, the studies conducted have found no difference in use of

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98. *Id.* at 771, n.18.

99. See Di Lorenzo, *Principles Based Regulation*, *supra* note 78, at 89–90; see also Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 97, at 782–803 (discussing cost-benefit evaluations of legal sanctions in the securities industry, and comparing it to cost-benefit evaluations in the banking industry and the industry’s compliance recorded under the Community Reinvestment Act); Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, 17 ACCOUNT. HORIZONS 91, 99–100 (2003) (study of accounting in the corporate context); see also Wayne B. Gray & John T. Scholz, *Does Regulatory Enforcement Work? A Panel Analysis of OSHA Enforcement*, 27 L. & SOC’Y REV. 177, 199 (1993); Steven Klepper & Daniel Nagin, *Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution*, 23 L. & SOC’Y REV. 209, 237 (1989). *Contra* John Braitwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 L. & SOC’Y REV. 7, 35 (1991) (study of Australian nursing homes).

100. Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 97, at 778–81, 790–94 (actions of securities analysts, 1998–2003); see also *id.* at 799–803 (actions of banks toward Community Reinvestment Act compliance, 1997–2000); Di Lorenzo, *Principles Based Regulation*, *supra* note 78, at 91–102 (actions of mortgage lenders, 2002–2008).

101. See Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 97, at 784; see also Di Lorenzo, *Principles Based Regulation*, *supra* note 78, at 91–102.

102. For a discussion of violations of state law by U.S. banking institutions in foreclosure proceedings and in bankruptcy proceedings, see Di Lorenzo, *Principles Based Regulation*, *supra* note 78, at 103.



decision-making heuristics in group decision making.<sup>103</sup> These behavioral tendencies and heuristics are explored below.

Decision-making heuristics can exaggerate the benefits and minimize the risks of noncompliance in decisions by industry actors. I will focus on two decision-making heuristics that can play a significant role in future decisions on compliance with regulatory mandates in the mortgage market: skewed risk perception and simplified decision making.

Skewed risk perception is the inverse relationship between perceptions of risks versus benefits. When a large benefit from evasion or noncompliance (e.g. large profits) is perceived, any risk posed by noncompliance (e.g. legal sanction) is viewed as low, regardless of the objective level of risk a disinterested third-party would perceive.<sup>104</sup>

Simplified decision making is a response to complexity due to many interacting variables and uncertainty regarding expected future outcomes,<sup>105</sup> such as the future likelihood of lawsuits and the possible exposure to liability as a result of lawsuits. When faced with such complexity individuals resort to a simplified decision-making strategy. The highest value is given to the choice that is the most important to the decision maker,<sup>106</sup> such as preserving high profits. In addition, risks that are viewed as low probability risks are ignored,<sup>107</sup> for example, substantial civil penalties imposed by regulators (if this has been rare in industry experience).

## **2. The U.S. Banking Industry as a Case Study: 2004–2008**

The actions of four major U.S. mortgage lenders in the period 2004 to 2008—Countrywide, Washington Mutual, Wachovia and IndyMac—illustrate the current business model, market realities and behavioral realities that led to the mortgage crisis. All four banks were declared insolvent after the mortgage crisis surfaced.

Countrywide illustrates a financial company business model that emphasized short-term profits. In an interview with examiners of the Financial Crisis Inquiry Commission, Angelo Mozilo defended his record as CEO of Countrywide by noting that Countrywide's stock value increased 25,000% from

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103. Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and Economics*, 56 *VAND. L. REV.* 1663, 1714 (2003); see, e.g., Colin F. Camerer & Ulrike Malmendier, *Behavioral Economics of Organizations*, in *BEHAVIORAL ECONOMICS AND ITS APPLICATIONS* 235, 260–64 (Peter Diamond & Hannu Vartiainen eds., 2007) (discussing studies documenting overconfidence on the part of executives).

104. See CASS R. SUNSTEIN, *RISK AND REASON* 40–41 (2002).

105. See Korobkin & Ulen, *supra* note 4, at 1077.

106. *Id.* at 1079.

107. Di Lorenzo, *Does the Law Encourage Unethical Conduct*, *supra* note 97, at 788.

1982 to August 2007.<sup>108</sup> After 2003, Countrywide changed its former policy of offering plain-vanilla, fixed rate loans, and increasingly offered “innovative,” riskier products.<sup>109</sup> Origination of riskier loan products increased profits and share price, not to mention executive compensation for Mozilo. Countrywide’s market share in the U.S. mortgage market increased from 11.4% in December 2003 to 15.7% in September 2006.<sup>110</sup> By 2005 Countrywide had become the largest mortgage lender in the United States. It recognized earnings of \$2.1 billion, \$2.4 billion, and \$2 billion in its loan production divisions in 2004, 2005, and 2006 respectively. The \$2.4 billion in earnings in 2004 represented an increase of 182% over earnings in 2002.<sup>111</sup> From 2000 until he left Countrywide in 2008, Mozilo received total compensation of \$521.5 million.<sup>112</sup>

Short-term profits were realized via lending products and practices that posed long-term risks, at times substantial risks. One loan product that posed substantial long-term risks was payment option adjustable rate mortgages (option ARMs). By 2005, option ARMs accounted for nineteen percent of Countrywide’s loan volume, making it the largest option ARM lender that year.<sup>113</sup> A supermajority of Countrywide’s option ARMs were “low documentation” loans in which the borrower did not fully document income or assets.<sup>114</sup> In the spring of 2006, e-mail messages from Mozilo revealed he was very concerned about the delinquency risks posed by such loans as borrowers faced payment shocks from resets. Nonetheless he actively promoted the company’s option ARM loans to investors at a Wall Street conference.<sup>115</sup> This was understandable in an environment emphasizing short-term profits since Countrywide’s gross profit margin was more than four percent on option ARMs, double the two percent profit margin generated by standard loans backed by the FHA.<sup>116</sup> Moreover, future risks were, hopefully, going to be shifted to purchasers of its mortgage backed securities. Payment option ARM loans that were securitized were sold by Countrywide and other originators to investors at higher prices, due to the higher interest rates they carried at reset as well as prepayment penalties. In addition, payment option ARMs that were kept in portfolio generated immediate phantom

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108. Ben Protess, *From Ex-Chief, A Staunch Defense of Countrywide’s Legacy*, N.Y. TIMES, Feb. 18, 2011, at B5. Thereafter, however, the share price fell more than ninety percent. *Id.*

109. See Gretchen Morgenson, *How Countrywide Covered the Cracks*, N.Y. TIMES, Oct. 17, 2010, at A1 [hereinafter Morgenson, *How Countrywide Covered the Cracks*].

110. Complaint for Violations of the Federal Securities Laws at 10, Sec. & Exch. Comm’n v. Mozilo, No. CV09-03994 (C.D. Cal. June 4, 2009) [hereinafter SEC Complaint], available at [www.sec.gov/litigation/complaints/2009/comp21068.pdf](http://www.sec.gov/litigation/complaints/2009/comp21068.pdf).

111. *Id.* at 7–8.

112. Gretchen Morgenson, *Lending Magnate Settles Fraud Case*, N.Y. TIMES, Oct. 16, 2010, at A1.

113. Simon & Hagerty, *supra* note 76.

114. *Id.* (91% of option ARMs in 2006 were low-documentation loans, 78% were low-documentation loans in 2004).

115. See Morgenson, *How Countrywide Covered the Cracks*, *supra* note 109.

116. *Id.*

profits because banks were able to report as current income the fully amortizing repayment amount even when borrowers made minimum payments.<sup>117</sup> At Countrywide such phantom income equaled \$654 million in 2006 and \$1.2 billion in 2007.<sup>118</sup>

Another risky underwriting practice was underwriting an ARM based on payments due at the initial, low interest rate. Countrywide later admitted that almost sixty percent of borrowers for whom it originated subprime hybrid ARMs would not have qualified at the fully indexed rate even if interest rates did not increase.<sup>119</sup> These underwriting practices, as well as the practice of underwriting no documentation loans, increased short-term fee income from origination fees since more borrowers “qualified” for such loan products, in contrast with fixed rate self-amortizing loans in which underwriting is based on a debt-to-income ratio based on fully amortizing repayments.

Skewed risk perception was evidenced in the actions of Countrywide from 2004 through 2008. This was demonstrated, in part, by the fact that not all risks loans originated were sold to investors. In 2005 and 2006, Countrywide maintained a majority of the option ARMs it originated in the investment portfolio of Countrywide Bank.<sup>120</sup> Moreover, as it originated riskier loan products a smaller percentage of loans that it did sell were eligible for sale on a nonrecourse basis.<sup>121</sup> The large profits produced by such loans caused Countrywide to ignore their long-term risks.

These high-risk loan products were also an important part of the mortgage lending business at Washington Mutual (WaMu). Option ARMs represented as much as half of all loan originations at WaMu from 2003 through 2007.<sup>122</sup> In addition, approximately 90% of WaMu’s home equity loans, 73% percent of option ARMs, and 50% of subprime loans were stated income (no-documentation) loans.<sup>123</sup>

Wachovia was similarly a major participant in the market for option ARMs. For example, it was the largest originator of such loans in the second quarter of 2007, followed by WaMu.<sup>124</sup> IndyMac was a fourth bank heavily involved in underwriting of high-risk loans in the 2004-2008 period. As late as

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117. Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK., Sept. 10, 2006, available at [http://www.businessweek.com/magazine/content/06\\_37/b4000001.htm](http://www.businessweek.com/magazine/content/06_37/b4000001.htm).

118. Complaint for Injunctive and Other Relief at 44, *State v. Countrywide Fin. Corp.*, No. 08CH22994 (Ill. Cir. Ct. June 25, 2008).

119. See S. REP. NO. 111-176, at 13 (2010).

120. SEC Complaint, *supra* note 110 at 10.

121. *Id.* at 14–15.

122. EVALUATION OF FEDERAL OVERSIGHT, *supra* note 77, at 9.

123. *Id.* at 10.

124. 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>.

the first quarter of 2007, only 21% of IndyMac's total loan production was in the form of full-documentation loans.<sup>125</sup>

As discussed above, no-documentation loans were a high-risk loan product offered by WaMu, Wachovia, IndyMac and Countrywide among others. Low-documentation or no-documentation loans were more profitable for originators in the short-term as well because borrowers were charged higher interest rates and fees for such loans and the loans could be approved more quickly thereby increasing loan volume.<sup>126</sup>

Such practices continued in a management environment that did not emphasize robust compliance with legal mandates, but instead creative noncompliance, and in a supervisory environment in which the risks and costs of lax compliance or noncompliance were small or nonexistent.

As early as 1993, the Real Estate Lending Standards applicable to all insured depository institution in the United States required that a firm's real estate lending standards "be consistent with "safe and sound banking practices," and establish "prudent underwriting standards."<sup>127</sup> The courts had noted that underwriting loans without regard to a borrowers' ability to repay could constitute an "unsafe" banking practice.<sup>128</sup> In addition, the Interagency Guidelines for Real Estate Lending Practices cautioned banks that "prudent" underwriting standards "should reflect *all* relevant credit factors including: [t]he capacity of the *borrower* . . . to adequately *service* the debt."<sup>129</sup>

In addition, the 2001 Expanded Guidance on Subprime Lending advised banks that examiners should classify as substandard all loans made in which the borrowers do not have the capacity to service their loans and, instead, lenders rely on the collateral pledged as the basis for repayment.<sup>130</sup>

Finally, in 2006, the Interagency Guidance on Nontraditional Mortgage Product Risks warned banks that a borrower's repayment capacity should be

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125. MIKE HUDSON, *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](http://www.responsiblelending.org/mortgage-lending/research-analysis/indymac_what_went_wrong.pdf). Figures are based on filings with the SEC. One year later IndyMac had changed this reliance on limited or no documentation loans, but by March 2008, sixty-nine percent of its loan volume involved full documentation mortgages, leaving almost one-third of its loan volume still in the form of limited or no documentation mortgages. See *id.* at 3 n.6.

126. Complaint for Injunctive and Other Relief, *State v. Countrywide Fin. Corp.*, No. 08CH22994, 2008 WL 2514791, at 28, para. 101 (Ill. Cir. Ct. June 25, 2008).

127. Real Estate Lending Standards, 12 C.F.R. § 365.2 (b)(1)–(2) (2010).

128. See *Gulf Fed. Sav. & Loan Ass'n of Jefferson Parish v. Fed. Home Loan Bank Bd.*, 651 F.2d 259, 264 (5th Cir. 1981) (discussing legislative history of the relevant banking statutes employing the safety and soundness requirement); see also *Northwest Nat'l Bank v. U.S. Dep't of the Treasury Office of the Comptroller of the Currency*, 917 F.2d 1111, 1113 (8th Cir. 1990).

129. Interagency Guidelines for Real Estate Lending Policies 12 C.F.R. pt. 365, subpt. A, app. A (emphasis added).

130. *BD. OF GOVERNORS, EXPANDED GUIDANCE*, *supra* note 9, at 9.

based on ability to repay at the fully indexed rate assuming a fully amortizing repayment schedule.<sup>131</sup> They also once again cautioned banks that loans in which borrowers do not demonstrate capacity to repay from sources other than the collateral pledged are generally considered unsafe and unsound loans.<sup>132</sup>

Regardless of these regulatory standards and lending guidelines, banking institutions such as Countrywide, WaMu, Wachovia, and IndyMac continued to make no documentation loans, and option ARMs, and to underwrite ARMs at the low initial interest rate. In addition, these risky product features were offered to subprime borrowers.

The federal banking regulators could have halted one or all of such practices by classifying them as unsafe or imprudent. Instead, regulators did not impose informal or formal written agreements on banking institutions requiring them to cease or alter the practices. They did not suspend individuals or impose penalties based on the unsafe and imprudent underwriting practices.

After the failure of Washington Mutual, the Inspector General reported that neither the OTS nor the FDIC took any action against WaMu based on its policy of originating risky option ARMs and no documentation loans until February 2008. At that point negotiations had commenced to arrive at a memorandum of understanding to correct the unsafe practices. However, by mid-September the bank was placed into receivership.<sup>133</sup> Similarly, at IndyMac no memorandum of understanding to change the bank's risky lending practices, such as underwriting no documentation loans, was entered into until June 25, 2008. On July 11, 2008, OTS closed the bank.<sup>134</sup>

#### **D. Supervisory Regulatory Reforms As a Necessary Response**

In light of a business model that emphasizes short-term profits and a resultant viewpoint that evasion of legal mandates can be a reasonable business decision, industry actors must assess the costs of noncompliance. Industry actors assess the risks of noncompliance in light of: (a) available sanctions, (b) available plaintiffs empowered to bring actions, (c) regulators' enforcement policies, and (d) enforcement record, primarily the frequency and likelihood of commencement of an action, and the severity of sanctions imposed. The first three factors influence a firm's view of the potential magnitude of the costs of noncompliance. However, the last factor is the key to widespread compliance in the long-term.

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131. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., INTERAGENCY GUIDANCE OF NONTRADITIONAL MORTGAGE PRODUCT RISKS 3 (2006), *available at* [www.federalreserve.gov/boarddocs/srletters/2006/SR0615a2.pdf](http://www.federalreserve.gov/boarddocs/srletters/2006/SR0615a2.pdf).

132. *Id.* at 4.

133. EVALUATION OF FEDERAL OVERSIGHT, *supra* note 77, at 33.

134. OFFICE OF EVALUATIONS, FED. DEPOSIT INS. CORP., Report No. EVAL-09-006, THE FDIC'S ROLE IN THE MONITORING OF INDYMAC BANK (2009), *available at* [www.fdic.gov/reports09/eval-09-006-508.shtml](http://www.fdic.gov/reports09/eval-09-006-508.shtml).

## **1. Regulators' Recognition of Influences on Corporate Compliance**

In recent years legislative and regulatory bodies in the United States and the United Kingdom have acknowledged that compliance with legal mandates is not to be presumed among industry actors. Implicitly, there has also been a recognition of cost-benefit evaluations as a basis for corporate decision making regarding legal compliance and, in turn, the substantial potential influence of legal sanctions. Thus, the Conference Report on the Dodd-Frank Act noted that effective consumer protection depends on laws and regulations being “vigorously enforced.”<sup>135</sup> Regulators in the United Kingdom have recognized the influence of enforcement efforts on corporate decision making, particularly the frequency and severity of sanctions.

The recent changes in the United States and the United Kingdom in regulatory alternatives and in viewpoint toward supervisory intervention are examined below. They are also evaluated in light of market realities and behavioral tendencies of industry actors.

## **2. Supervisory Reforms in the United States and the United Kingdom.**

In the United States the major supervisory changes introduced involve (a) expansion of available plaintiffs empowered to seek one or more sanctions for legal noncompliance, and (b) a small expansion of available sanctions. These changes offer the potential for a change in industry cost-benefit evaluations regarding legal compliance—but only a potential. Whether industry actors will indeed alter cost-benefit evaluations will depend on agency enforcement policy and enforcement record. To date no change on the part of U.S. regulators has been demonstrated on either front.

In the United Kingdom there has been a change in all four factors that influence industry assessments of the risk of noncompliance, and the changes were initiated earlier. The most significant changes have been in enforcement policy and enforcement record. Each factor influencing industry assessments of risks of noncompliance is discussed below.

### **a. Available Plaintiffs**

The Dodd-Frank Act creates three new available plaintiffs to enforce federal consumer financial laws. First, it creates a new Consumer Financial Protection Bureau charged with enforcement of federal consumer financial laws.<sup>136</sup> The Bureau also is granted supervisory authority over “covered persons,”

135. See H.R. CONF. REP. NO. 111-517, at 874 (2010).

136. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, § 1089, 15 U.S.C. § 1692 et seq. (West, Westlaw 2012). An exception is provided, however, for insured depository

which include state chartered entities that originate, broker, or service consumer mortgage loans.<sup>137</sup>

Second, state attorneys general are granted new authority to enforce the minimum underwriting requirements imposed in Title 14 of the Dodd-Frank Act, and the consumer protection provisions and regulations issued under Title 10 of the Act.<sup>138</sup>

Third, consumers are empowered to raise certain defenses, in the form of recoupment or set off of damages, in mortgage foreclosure actions.<sup>139</sup> This encompasses a defense based on violation of (a) the anti-steering prohibition in the Act—prohibiting broker compensation based on the terms of the mortgage loan—and (b) the requirement that loans are based on a reasonable and good faith ability of the consumer to repay.

In the United Kingdom, a Consumer Protection and Markets Authority, now to be called the Financial Conduct Authority, is being created, with a focus on protection of consumers.<sup>140</sup> Its powers will include rule-making, supervision, enforcement and approvals for conduct of activities. This is, of course, similar to the change embraced in the United States—which established a dedicated consumer financial protection regulator.

These modifications change the probability assessment of risks of noncompliance in the short-term. However, in the long-term it is enforcement policy and record that is necessary to alter industry cost-benefit evaluations. Even in the short-term it is unlikely that the greater expansion of available plaintiffs in the United States will have a significant impact on risk assessments. State regulators could always bring actions against state chartered mortgage companies in the United States, which were responsible for the majority of subprime and high risk loans, as well as state chartered depository institutions. However, resource limitations led to few enforcement actions and as a result, the probability of a state-initiated enforcement action based on offerings of unsafe or unfair mortgage products was properly viewed as a low probability risk. Passage of the Dodd-Frank Act expanded the legal bases for state-initiated action, but the cause of past inaction remains unchanged. Indeed, in recent years state budgets have become more cash-strapped.

Granting private plaintiffs defenses to foreclosure actions is the other change in U.S. law. It is one that expands the number of available “plaintiffs” (claimants) that may seek a sanction for legal noncompliance with minimum

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institutions and credit unions with assets of \$10 billion or less. Enforcement power is retained by the prudential regulator for such entities. *See id.* § 1026(d), 12 U.S.C. 5516(d) (West, Westlaw 2012).

137. *Id.* § 1024, 12 U.S.C. § 5514 (West, Westlaw 2012).

138. *Id.* § 1042, 12 U.S.C. § 5552 (2012), § 1422, 15 U.S.C. § 1640(e) (West, Westlaw 2012).

139. *Id.* § 1413, 15 U.S.C. § 1640(k) (West, Westlaw 2012).

140. H.M. TREASURY, A NEW APPROACH TO FINANCIAL REGULATION: JUDGMENT, FOCUS AND STABILITY, 2010, Cm. 7874 at 31–41 (U.K.), available at [http://62.164.176.164/d/consult\\_financial\\_regulation\\_condoc.pdf](http://62.164.176.164/d/consult_financial_regulation_condoc.pdf).

mortgage underwriting requirements and expands available sanctions as well. However, when substantial profits are being generated by riskier loan products, this possible, future litigation will be viewed as a low probability risk. The private plaintiffs' defenses create potential future risks that may arise when there is a downturn in the market and become significant only if the downturn results in a substantial number of foreclosures. However, ex ante risks from future market downturns were ignored by industry actors as low probability risks due to the compelling motivation to preserve substantial profits generated by products and services that could have been deemed "unsafe and unsound" or "imprudent."

#### b. Available Sanctions

The Dodd-Frank Act enumerates the remedies the Consumer Financial Protection Bureau is authorized to seek for violations of federal consumer financial laws.<sup>141</sup> Such remedies largely duplicate the remedies the federal banking agencies could already impose under the FDIC Act based on unsafe banking practices.<sup>142</sup> However, two modest changes have been made: (a) remedies, including imposition of a civil money penalties, can now be based on a violation of the federal financial consumer laws, as opposed to the banking laws, and (b) the criteria for imposition of civil money penalties has been simplified.<sup>143</sup>

In the United Kingdom, available sanctions were substantially strengthened in comparison with the FSA's earlier powers. The FSA was granted the power to suspend a person, including a firm, from conducting an authorized activity for up to twelve months, or to restrict such activity.<sup>144</sup> Such suspension could now also be coupled with the imposition of a penalty.<sup>145</sup> In addition, the FSA was empowered to require a firm to put in place a "consumer redress

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141. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, § 1055, 12 U.S.C. § 5565 (West, Westlaw 2012).

142. 12 U.S.C. § 1818 (West, Westlaw 2012).

143. Dodd-Frank Act, § 1055(c), 12 U.S.C. § 5565(c) (West, Westlaw 2012). The Dodd-Frank Act retains the requirement of "reckless" conduct, but eliminates the need to prove a pattern of misconduct, or a likelihood of more than minimal loss to the institution, or a pecuniary gain or benefit to the wrongdoer in order to recover a second tier penalty of not more than \$25,000 for each day a violation continues. *See id.* The Act retains the need to prove a "knowing" violation for a third tier penalty of not more than \$1 million per day, but eliminates the need to prove the wrongdoer caused a substantial loss to the institution or substantial gain or benefit to the wrongdoer. *See id.*

144. Financial Services Act, *supra* note 45, § 9 (authorized person and authorized activity); *see also* FIN. SERVS. AUTH., CONSULTATION PAPER 10/11, IMPLEMENTING ASPECTS OF THE FINANCIAL SERVICES ACT 2010 15–21 (2010) [hereinafter IMPLEMENTING THE FSA], available at [http://www.fsa.gov.uk/pubs/cp/cp10\\_11.pdf](http://www.fsa.gov.uk/pubs/cp/cp10_11.pdf).

145. Penalties were authorized in the Financial Services Market Act 2000. *See* FIN. SERVS. AUTH., CONSULTATION PAPER 09/19, ENFORCEMENT FINANCIAL PENALTIES 5 (2009).



scheme” when it has violated legal requirements and its actions resulted in, or may result in, loss or damage to consumers.<sup>146</sup>

Impositions of substantial penalties and suspension of individuals and firms are important tools that raise the specter of substantial, potential risks in cost-benefit evaluations by industry actors. However, in the United States such sanctions against individuals or firms have rarely been applied for mortgage underwriting abuses. As a result, they were discounted as low probability risks. Thus, enforcement policy and enforcement record become the primary influences on industry cost-benefit evaluations in the long-term.

### c. Enforcement Policy

The enforcement policy of the U.S. federal bank regulators has traditionally been to rely on informal agreements, formal agreements and cease and desist orders when faced with legal noncompliance.<sup>147</sup> Under this policy, when firms fail to comply with legal mandates they can expect to face only an agreement or order to cease the operations in question. As a result, firms are not fined for past violations and, in fact, often retain all the benefits (profits) of past practices conducted in violation of legal mandates. In addition, firms have not been temporarily barred from conducting a line of business as a penalty for past wrongdoing. Since the outbreak of the mortgage crisis, the federal banking agencies have not announced any change in their enforcement policy with respect to underwriting practices that might be deemed “unsafe” from the standpoint of a prudential regulator. They also have not altered their lax enforcement record.

This light-touch approach to enforcement is also reflected in a policy of the Justice Department, as well as the SEC, that has existed at least since 2005. This is the policy of using “deferred prosecution agreements” or “non-prosecution agreements.” In such agreements, no actions are commenced if firms investigate their own past wrongdoing and promise to change their behavior.<sup>148</sup> This policy became the official policy of the Justice Department in 2008, just as the financial crisis unfolded.

In cases involving deferred- or non-prosecution agreements, agency-written agreements, and cease and desist orders not involving financial penalties or suspensions against firms, industry cost-benefit evaluations recommend creative compliance, creative noncompliance or even violation of legal requirements. Based on this enforcement policy, if a firm is found to violate legal

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146. Financial Services Act, *supra* note 45, § 14.

147. See *infra* notes 173–75 and accompanying text.

148. Gretchen Morgenson & Louise Story, *Behind the Gentler Approach to Banks* by U.S., N.Y. TIMES, July 8, 2011, at A1, available at [http://www.nytimes.com/2011/07/08/business/in-shift-federal-prosecutors-are-lenient-as-companies-break-the-law.html?pagewanted=all&\\_r=1](http://www.nytimes.com/2011/07/08/business/in-shift-federal-prosecutors-are-lenient-as-companies-break-the-law.html?pagewanted=all&_r=1) (as *As Wall St. Polices Itself, Prosecutors Use Softer Approach*, N.Y. TIMES, July 7, 2011).

requirements they are only required to cease the conduct in question. Yet, profits from past misconduct remain with the firm.

The Consumer Financial Protection Bureau is a new entity whose enforcement policy and enforcement record will play an important role in future industry cost-benefit evaluations. However, the Bureau has not yet announced an enforcement policy, and, of course, has not yet commenced the exercise of its enforcement authority.

The United Kingdom, by contrast, has witnessed a significant change in both enforcement policy and enforcement record. Three changes have been announced and have begun to be implemented: (a) an early intervention policy triggered by revelation of potential risks to consumers, (b) penalties, imposed against firms and individuals, based on income to achieve credible deterrence, and (c) an enforcement policy increasingly utilizing suspension of individuals and firms as a sanction.

A major change in FSA enforcement policy is an emphasis on early intervention. The FSA has stated, “We will now intervene earlier in the product value chain, proactively, to anticipate consumer detriment where possible and stop it before it occurs.”<sup>149</sup> Expansive powers of product intervention, including the power to approve and preemptively ban or restrict sale of certain products to retail customers, are expected to be given to FCA when it inherits FSA’s enforcement responsibilities in 2013.<sup>150</sup> In addition, the Financial Services Authority has noted that its future supervisory approach will be based on a detailed analysis of a firm’s business model which could give rise to conduct risks.<sup>151</sup>

The FSA recognized that its enforcement powers must be used to deter noncompliance. In deciding whether to impose a penalty and what penalty should be imposed, the FSA has announced that “the financial penalty should be sufficient to deter the person who committed the breach from committing further breaches and also deter other persons from committing similar breaches.”<sup>152</sup> To emphasize this goal, the FSA implemented a penalty framework that links penalties to benefits firms receive from noncompliance. Specifically, penalties are based on a percentage of the firm’s “pre-tax income over the period of the breach from the product or business area to which the breach relates.”<sup>153</sup> For firms this percentage can be from zero to twenty percent of the firm’s pre-tax income. For individuals it can be from zero to forty percent of the individual’s relevant pre-tax income from the relevant employment in connection with which the breach

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149. See PRODUCT INTERVENTION, *supra* note 11 at 9; see also APPROACH TO REGULATION, *supra* note 31, at 17.

150. PAUL HINTON & ROBERT PATTON, TRENDS IN REGULATORY ENFORCEMENT IN U.K. FINANCIAL MARKETS: FISCAL YEAR 2011/12, at 5, 31 (2012) [hereinafter HINTON & PATTON 2012], available at [http://www.nera.com/67\\_7761.htm](http://www.nera.com/67_7761.htm) (citing FSA discussion paper and FCA statement of policy-making on product intervention).

151. PRODUCT INTERVENTION, *supra* note 11, at 34.

152. ENFORCEMENT FINANCIAL PENALTIES, *supra* note 145, at 7.

153. *Id.*

occurred for the period of the breach.<sup>154</sup> The amount of the penalty is based on relevant income, because, “the extent of the income generated by a firm from a particular product or business area is relevant in terms of the size of the financial penalty necessary to act as a credible deterrence.”<sup>155</sup> To achieve credible deterrence, the FSA has also proposed doubling or tripling penalties on larger firms and high-earning individuals compared to their prior levels.<sup>156</sup>

Finally, the FSA recognized that suspension of a firm from conducting an authorized activity has a substantial impact on the firm’s cost-benefit evaluation concerning noncompliance and on the industry’s evaluation of future conduct. As the FSA noted:

Our proposed approach is to use the suspension power where we consider that the imposition of a suspension will be a more effective and persuasive deterrent than the imposition of a financial penalty alone. We believe there will be circumstances where this will be the case because, as mentioned above, suspending a person from carrying on particular activities could have a more direct and visible effect on that person than a financial penalty. For example, if we prevent a firm from selling a particular product for a period of time, this action is likely to have a more immediate and practical effect on the firm, and be more obvious to external parties and therefore a greater deterrent, than the imposition of a financial penalty.<sup>157</sup>

In all cases the aim is not merely to provide redress for the harm caused by noncompliance, and to eliminate any financial gain or benefit from noncompliance. The aim of the FSA is also to change the behavior of the person who is subject to its enforcement action and to deter future noncompliance by others.<sup>158</sup>

An early intervention strategy can halt industry products and practices that are structured to evade or fail to comply with legal requirements before they generate substantial profits for the firm—profits that the firm then seeks to preserve and that impair its assessment of risks. Penalties based on profits from an entire line of business can impose more substantial losses than fines or civil penalties. Moreover, they target the very benefit that is of paramount importance to industry actors. Suspensions aimed at firms or lines of business similarly target

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154. *Id.*; see also FIN. SERV. AUTH., DECISION PROCEDURE AND PENALTIES MANUAL 17, decs. 6.5A.2, 6.5B.2 (2010) (the higher penalties are based, in part, on whether the breach caused a significant loss or risk of loss to individual consumers and the breach was committed deliberately or recklessly).

155. See ENFORCEMENT FINANCIAL PENALTIES, *supra* note 145, at 7.

156. See *id.* at 8.

157. IMPLEMENTING THE FSA, *supra* note 144, at 17; see also DECISION PROCEDURE AND PENALTIES, *supra* note 154, at 6A.1.3, 6A.2.3, 6A.3.2.

158. THE ENFORCEMENT GUIDE, *supra* note 62, at 5.

profits, in this case future profits. In industry cost-benefit evaluations, such altered enforcement policies modify industry assessments. Profits are no longer solely a benefit flowing from current products and practices. Rather they become a component of risk in that they become part of the sanction. The most important goal for industry actors—generating and preserving profits—is placed at risk in the event of noncompliance. In order for industry cost-benefit evaluations to be altered in the long-term, however, such sanctions must actually be imposed.

The U.S. agencies' failure to consider a revised supervisory enforcement policy, similar to the FSA's new policies, is curious given their experience with the Community Reinvestment Act (CRA). The CRA was enacted in 1977 and requires banking institutions to meet the credit and deposit service needs of their local communities including low- and moderate-income neighborhoods.<sup>159</sup> Through 1988, U.S. banks faced few sanctions for failure to comply with the CRA and largely ignored its requirements. Starting in 1989 and continuing through the Clinton administration, federal banking regulators denied applications for expansion by banking institutions with poor CRA records with greater frequency.<sup>160</sup> This sanction, authorized by the CRA,<sup>161</sup> had a direct impact on bank profits. The response by the U.S. banks was dramatic. As of 1985, U.S. banks had committed \$3.7 billion to CRA lending. By 1993, such commitments exceeded \$30 billion, increased to more than \$397 billion by the first quarter of 1998, and reached \$1 trillion in the fall of 1998.<sup>162</sup>

#### d. Enforcement Record

In the United Kingdom the change in announced enforcement policy has been coupled with a significant change in the FSA's enforcement record. FSA fines have increased in four consecutive years, from a low of £4.4 million in 2007–2008, to £98.6 million in 2010–2011.<sup>163</sup> Total fines for 2011–2012 were £78.5 million, but after excluding the very largest fines the aggregate fines for firms and individuals in 2011–2012 rose nearly twenty percent over 2010–2011.<sup>164</sup> For firms, aggregate fines in 2010–2011 were seven times the annual average over the six years prior to 2008–2009. For individuals, aggregate fines in 2010–2011 were twenty-two times the annual average over the six years prior to 2008–

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159. 12 U.S.C. §§ 2901, 2903 (West, Westlaw 2012).

160. See Vincent Di Lorenzo, *Equal Economic Opportunity: Corporate Social Responsibility in the New Millennium*, 71 U. COLO. L. REV. 51, 100 (2000) [hereinafter Di Lorenzo, *Equal Economic Opportunity*].

161. 12 U.S.C. § 2903.

162. Di Lorenzo, *Equal Economic Opportunity*, *supra* note 160, at 116–17.

163. See PAUL HINTON & ROBERT PATTON, TRENDS IN REGULATORY ENFORCEMENT IN U.K. FINANCIAL MARKETS 3 (2011) [hereinafter HINTON & PATTON 2011], available at [http://www.nera.com/67\\_7357.htm](http://www.nera.com/67_7357.htm).

164. HINTON & PATTON 2012, *supra* note 150, at 1–2.

2009.<sup>165</sup> The total fines imposed on individuals in 2011–2012 were more than twice the level in 2010–2011.<sup>166</sup> Moreover, this increase in frequency and overall level of fines occurred before the FSA implemented its new penalty policies of (a) potentially doubling or tripling fines in case involving large firms, and (b) basing fines on income from overall operations in areas in which misconduct occurred, in order to effectively create an environment of credible deterrence.<sup>167</sup>

Suspensions have increased as well. Fifty mortgage intermediaries were banned in 2008–2009 based on fraud or malpractice<sup>168</sup> and, through January 2010, 101 intermediaries have been banned.<sup>169</sup> Many of the bans involve false or misleading information provided on mortgage applications.<sup>170</sup> Suspensions and prohibition sanctions are now nearly as common as fines.<sup>171</sup>

The credible deterrence strategy has been implemented not only by an increase in the number of industry suspensions and an increase in the number and size of fines. It has also been implemented through an increase in staffing within the FSA's enforcement division of forty-two percent between 2007–2008 and 2010–2011.<sup>172</sup>

In the United States, federal banking regulators rarely brought supervisory action to address unfair or unsafe mortgage lending practices prior to the recent mortgage crisis.<sup>173</sup> When enforcement actions of any kind and based on any violation were brought, they typically involved a written agreement to correct past violations and occasionally a cease and desist order.<sup>174</sup> Both written agreements and cease and desist actions orders typically merely outline corrective actions a financial institution's management and directors must take to address deficiencies in the institution's operations.<sup>175</sup>

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165. HINTON & PATTON 2011, *supra* note 163, at 2.

166. HINTON & PATTON 2012, *supra* note 150, at 1.

167. See *supra* text accompanying note 156.

168. MORTGAGE MARKET REVIEW, *supra* note 11, at 94.

169. See FIN. SERVS. AUTH., ANNUAL REPORT 2010/11 74 (2011), available at [http://www.fsa.gov.uk/pubs/annual/ar10\\_11/ar10\\_11.pdf](http://www.fsa.gov.uk/pubs/annual/ar10_11/ar10_11.pdf). More than 200 individuals have been banned from the industry from 2007 through June 2011. See Chris Salih, *FCA Set to Increase Enforcement Action*, MONEY MARKETING, June 27, 2011.

170. *Six Are Banned for Mortgage Fraud*, BBC (July 5, 2010, 7:44 AM), <http://www.bbc.co.uk/news/10509324>.

171. HINTON & PATTON 2011, *supra* note 163, at 2. There were sixty-five prohibitions in 2010–2011, fifty-seven in 2009–2010 and forty-eight in 2008–2009. This compares with ten in 2006–2007, seven in 2005–2006, nine in 2004–2005, nine in 2003–2004, and four in 2002–2003. See *id.* at 22.

172. See *id.* at 20.

173. See Di Lorenzo, *Principles Based Regulation*, *supra* note 78, at 95–99.

174. See *id.* at 97–98.

175. Jackie Brunmeier & Niel Willardson, *Supervisory Enforcement Actions Since FIRREA and FDICIA*, THE REGION, FED. RESERVE BANK OF MINNEAPOLIS (Sept. 1, 2006), [www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=3222](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3222). The article also discusses trends in civil money penalties 1989–2005 and finds that one percent of all civil money penalties imposed 1999–2005 were based on consumer protection violations.

Criminal actions against individuals and firms might lead to deterrence. However, through August 2011, the U.S. Justice Department had initiated only three cases against employees at large financial companies and none against executives at large banks.<sup>176</sup> It has decided, for example, to bring no actions against individuals at Washington Mutual or at Countrywide based on the firms' risky lending practices leading to the mortgage crisis.<sup>177</sup>

Focusing specifically on the issue of unfair mortgage origination products and practices, the Federal Reserve Board has only recently brought the first action ever initiated by any federal banking regulator for the unfair lending practice of steering borrowers into high cost loans. In July 2011, Wells Fargo was subjected to a penalty of \$85 million as part of a cease and desist order.<sup>178</sup> No larger penalty had ever been imposed by the Federal Reserve in a consumer protection enforcement action.

Turning to unsafe products and practices, the only significant administrative actions taken by any of the U.S. banking agencies in recent years are the lawsuits filed by the FDIC, as receiver of federally insured institutions, against officers and directors of failed institutions. Such actions are authorized to recover losses suffered by the FDIC.<sup>179</sup> As of October 9, 2012, the FDIC has authorized eighty lawsuits related to the insolvency of depository institutions and filed thirty-three.<sup>180</sup> However, the FDIC's actions are not likely to alter future industry cost-benefit evaluations concerning legal compliance. The claims filed can be initiated only after unsafe loans lead to defaults, the numbers of defaults multiply, and the losses suffered by the institution reaches the point that the institution is declared insolvent. In the 2003–2007 period the risk of long-term defaults and the risk of a substantial number of defaults were ignored by industry actors due to both the originate-to-sell business model and skewed risk perception. Thus, the additional long-term risk of defaults leading to insolvency of the institution and subsequent action on the part of the FDIC to recover losses would also be ignored, *ex ante*, by industry actors. The industry had witnessed similar lawsuits, *ex post*, by the FDIC after the savings and loan crisis.<sup>181</sup> That history had little or no deterrent effect on industry actions in 2003–2007.

A similar conclusion can be drawn with respect to the *ex post* civil actions filed in 2011 and 2012 by the Justice Department to recover losses

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176. Louise Story & Gretchen Morgenson, *A.I.G. Sues Bank of America Over Mortgage Bonds*, N.Y. TIMES, Aug. 8, 2011, at A3.

177. *Id.*

178. Press Release, Bd. of Governors of the Fed. Reserve Sys. (July 20, 2011), <http://www.federalreserve.gov/newsevents/press/enforcement/20110720a.htm>.

179. 12 U.S.C. §1821(k) (West, Westlaw 2012).

180. FED. DEPOSIT INS. CORP., PROFESSIONAL LIABILITY LAWSUITS, *available at* [www.fdic.gov/bank/individual/failed/pls](http://www.fdic.gov/bank/individual/failed/pls) (the thirty-three lawsuits filed name 272 former directors and officers of failed institutions, including Washington Mutual and IndyMac).

181. FED. DEPOSIT INS. CORP., STATEMENT CONCERNING THE RESPONSIBILITIES OF BANK DIRECTORS AND OFFICERS, *available at* <http://www.fdic.gov/regulations/laws/rules/5000-3300.html>. As of December 1992 the FDIC had brought suit or settled claims against former directors and officers of twenty-four percent of the banks that failed since 1985. *Id.*

suffered by Fannie Mae, Freddie Mac and FHA.<sup>182</sup> They were filed long after the unsafe loans were originated<sup>183</sup>—loans that were extremely profitable to the originators in the short-term. They were filed only after long-term defaults in a substantial number of loans were experienced, a risk industry members would ignore in a robust market. Finally, the government has recovered relatively small sums in relation to the substantial, short-term profits the originators enjoyed from unsafe loans in 2003–2007.<sup>184</sup>

The FDIC actions, and the recent Justice Department civil actions, are very different from the early intervention strategy introduced by the FSA and its related credible deterrence approach relying of profit-based sanctions. Properly employed, that approach would lead to intervention before industry actions could generate profits significant enough to skew risk perception, and would also alter cost-benefit evaluations by causing noncompliance to directly impact both past and, in the case of firm suspensions, future profits.

#### IV. CONCLUSION

Do the regulatory reforms in the United States or the United Kingdom alter industry cost-benefit evaluations of the benefits and risks of noncompliance? As indicated in Part II of this article the product reforms enacted in both the United States and the United Kingdom would prohibit the practice of omitting to verify a borrower's income or assets. However, the product reforms in the United States would not clearly prohibit future high-risk underwriting practices because underwriting is not required to be based on income, and capped at safe, maximum debt-to-income ratios and loan-to-income ratios. Thus, in a market in which risky loan products generate significant profits—as was true in the period prior to 2008—regulators' enforcement policy and record must create an environment in which the benefits of evasion or noncompliance are deemed by industry to be outweighed by supervisory risks. In the United States, such supervisory risks remain unchanged. Particular practices might have been altered, such as the practice of obtaining no verification of income or assets, but overall levels of risk

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182. See Peter Lattman, *U.S. Accuses Wells Fargo of Lying About Mortgages*, N.Y. TIMES, Oct. 10, 2012, at B3. United States prosecutors accused Wells Fargo of defrauding the government for more than a decade by recklessly originating mortgages and then making false certifications about their condition to the Federal Housing Administration. *Id.* A number of banks have settled cases related to their lending practices: Deutsche Bank which paid more than \$200 million to resolve civil fraud charges; Citigroup which settled claims for \$158 million; and Bank of America for \$1 billion in a settlement connected to its Countrywide Financial business. *Id.*

183. Some cases were filed so long after the mortgage crisis that the Second Circuit is considering whether they are time-barred. See *Second Circuit Considers Timeliness in FHFA Litigation on Mortgage Securities*, 99 BNA'S BANKING REPORT 917, 917 (2012) (discussing Federal Housing Finance Agency v. UBS Americas, Inc., No. 12-3207 (2d Cir., appeal argued Nov. 26, 2012)).

184. See Lattman, *supra* note 182.

might very well remain unchanged when the market recovers. This is because industry cost-benefit evaluations would have been largely the same had the Dodd-Frank Act been enacted in 2002 rather than 2010. Enormous profits generated by risky lending practices would cause industry actors to discount legal risks of noncompliance as low probability risks which, if encountered, also imposed low costs for noncompliance.

A different conclusion can be reached with respect to regulatory reforms in the United Kingdom. Product reforms, to date, require verification of income and tighten standards for determinations of “affordability.” However, as in the United States, evasion through creative noncompliance would allow the goal of truly affordable, safe mortgage products to be disserved, since there are no quantitative standards to determine affordability and no maximum loan-to-value limits to buffer risks. Industry conduct will therefore be based on evaluation of risks against the benefits of noncompliance. In the United Kingdom, the recent changes in enforcement policies and the FSA’s recent enforcement record are likely to alter industry cost-benefit evaluations in favor of a greater commitment to prudent (safe) underwriting practices and consumer protection standards. Assuming the FSA imposes significant income-based penalties under its new enforcement policy, and imposes a fair number of suspensions with respect to noncompliant industry lines of business, credible deterrence is likely to be realized in the United Kingdom. It is far less likely to be realized in the United States.

The mortgage market experience of the last decade revealed that legal compliance is less dependent on whether a regulatory regime is rules-based or principles-based and more dependent on supervisory enforcement policy and record. In choosing the type and level of sanction required for credible deterrence, regulators must take into account that decisions on legal compliance are based on cost-benefit evaluations. Evasion or noncompliance can, at times, generate substantial profits, and when faced with substantial profits industry actors discount noncompliance risks as low probability risks. Therefore, regulatory enforcement policy and enforcement records must alter industry cost-benefit evaluations. They must convince industry actors that supervisory action is likely and that its costs will outweigh the profits generated by evasion or noncompliance.

