Pace Law Review

Volume 30
Issue 1 *Fall 2009*
Real Property, Mortgages, and the Economy: A Call for Ethics and Reforms

Article 21

September 2009

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Recommended Citation
Prentiss Cox, *The Importance of Deceptive Practice Enforcement in Financial Institution Regulation*, 30 Pace L. Rev. 279 (2009)
Available at: http://digitalcommons.pace.edu/plr/vol30/iss1/21

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A NEW HORIZON: LEGAL REFORMS, NEW REGULATORY MODELS, PREDICTIONS

The Importance of Deceptive Practice Enforcement in Financial Institution Regulation

Prentiss Cox*

No more bytes need be consumed nor ink spilled to observe that the rampant abuse and negligence in residential mortgage lending over the last ten years was a disaster for America and beyond. Because this concept has attained near universal recognition, there has been a struggle to define exactly what happened and who was responsible. How we collectively write this story affects how government will respond to the long-term problems in the market exposed by the mortgage collapse.

Subprime mortgage lending was a disaster for hundreds of thousands of American homeowners long before it was at the center of the popular understanding of the financial crisis. The history of harm to American homeowners, and the utter failure of the American regulatory system to grasp and rectify these problems until it was too late to contain the damage to the financial system, offers valuable lessons for how we should structure the reform of our financial institutions.

The thesis of this Article is that enforcement of consumer protection laws prohibiting unfair and deceptive acts and practices should be part of the core mission of the re-structured financial regulatory system. Soaring defaults in mortgage loans and accompanying devastation to the credit markets could have been averted if the persistent concerns raised by consumer advocates working with subprime borrowers in the late 1990s and early 2000s had been given serious and prompt

attention.[1] Not only the consumer financial services industry,

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1. *See, e.g.*, *Promoting Home Ownership by Ensuring Liquidity in the Subprime Mortgage Market: Joint Hearing Before the H. Subcomm. on Financial Institutions and Consumer Credit and the H. Subcomm. on Housing and Community Opportunity of the H. Comm. on Financial Servs.*, 108th Cong. 19 (2004) (statement of Michael D. Calhoun, General Counsel, Center for Responsible Lending) [hereinafter Calhoun 2004 testimony] (stating that "[t]he continuation of unchecked predatory loan practices gravely threatens homeownership and equity of families," encouraging the committee "to enact effective federal protections like those in North Carolina" including assignee liability, and noting that "federal protections should be a floor, not a ceiling"); *Subprime Lending: Defining the Market and its Customers: Before the H. Subcomm. on Financial Institutions and Consumer Credit and the H. Subcomm. on Housing and Community Opportunity of the H. Comm. on Financial Servs.*, 108th Cong. 68 (2004) (statement of Eric Stein, Senior Vice President, Center for Responsible Lending of North Carolina) [hereinafter Stein 2004 testimony] (discussing the impact of North Carolina's anti-predatory lending law, noting that "limiting upfront fees . . . has eliminated a lot of the equity stripping abuses . . . [and] borrowers[ ] who qualify for conventional loans[ ] are actually getting conventional loans"); *Predatory Lending Practices: Before the H. Comm. on Banking and Financial Servs.*, 106th Cong. 107 (2000) (statement of Margot Saunders, Managing Attorney, National Consumer Law Center) [hereinafter Saunders 2000 testimony] (discussing the limitations of the Home Ownership Equity Protection Act, which "only covers 1 percent of the subprime loans . . . [and] doesn't adequately address [predatory lending] by prohibiting real problem terms"); *Id.* (written statement of John E. Taylor, President and CEO, National Community Reinvestment Coalition) [hereinafter Taylor 2000 written testimony] (discussing NCRC and the Rainbow/PUSH Coalition's initiative to "combat Wall Street financing of predatory lending" and encouraging the Federal Reserve Board to use its authority to regulate mortgage lenders that are the subsidiaries of bank holding companies as well as "many companies that underwrite, purchase, and service mortgage-backed securities based on subprime loans by non-bank lenders"); *Reform of the Real Estate Settlement Procedures Act (RESPA) and Truth in Lending Act (TILA): Before the H. Subcomm. on Financial Institutions and Consumer Credit and the H. Subcomm. on Housing and Community Opportunity of the H. Comm. on Banking and Financial Servs.*, 105th Cong. 138 (1998) (statement of Margot Saunders, Managing Attorney, National Consumer Law Center) [hereinafter Saunders 1998 testimony] ("[A]busive loan protections are very, very necessary, and it would be inappropriate to proceed with amending the only two Federal laws that essentially govern mortgages in this country without dealing with the abusive loans that we see every day in every State in the country."); *Id.* (written statement of Margot Saunders, Managing Attorney, National Consumer Law Center) [hereinafter Saunders 1998

but also many regulators, legislators and academics viewed consumer protection as either irrelevant to core regulatory objectives or antithetical to market efficiency and growth.[2] They were wrong. Government agencies and public interest entities primarily focused on consumer protection were sounding the alarm about the practices that caused the mortgage collapse for almost a decade before financial system regulators began to take the problem seriously.[3] Consumer protection concerns should be at the core of the regulatory system mission, partly to ensure that lending institutions are financially sound in the long-term.

Part I of this Article examines the federal and state regulatory system for mortgage lending and identifies regulators responsible for enforcing consumer protection laws applicable to mortgage origination. Part II reviews how those regulators performed in the years leading up to the mortgage crisis, including the state consumer protection actions that highlighted, at an early stage, the fundamental problems with mortgage lending. Part III suggests some ideas for how to build a consumer protection focus within the financial institution

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written testimony] (discussing the failure of the marketplace to protect consumers, making recommendations for improving disclosure requirements, proposing substantive protections for borrowers, and opposing moratoria on class action lawsuits regarding illegal lender-paid mortgage broker fees).

2. *See, e.g.*, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 86-95 (2008) (describing banking agencies' disinterest in exercising their powers to develop consumer protection regulations and the Office of the Comptroller of the Currency's efforts to assert federal preemption of state consumer protection laws). *See generally* Richard A. Epstein, *The Neoclassical Economics of Consumer Contracts*, 92 MINN. L. REV. 803 (2008).

3. *See, e.g.*, Saunders 2000 testimony, *supra* note 1; Taylor 2000 written testimony, *supra* note 1; Saunders 1998 testimony, *supra* note 1; Saunders 1998 written testimony, *supra* note 1. *See also* Robert Berner & Brian Grow, *They Warned Us*, BUS. WK., Oct. 20, 2008 (discussing the efforts of Iowa, North Carolina, Georgia, Michigan, and the City of Cleveland to regulate predatory lending during the early 2000s and federal preemption of state regulatory authority); Letter from Donald S. Clark, Secretary, Federal Trade Commission, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System (Mar. 9 2001), *available at* http://www.ftc.gov/be/v010004.shtm (commenting on proposed amendments to Regulation Z implementing the Home Ownership and Equity Protection Act ("HOEPA"); recommending expansion of HOEPA; and noting "the link between subprime lending and foreclosure rates, the latter of which have increased more than the market share of subprime loans").

regulatory structure.

I. Consumer Protection and Mortgage Lending Regulation

Two related questions often raised in discussing the mortgage meltdown are: (1) why did so many American homeowners obtain mortgage loans that ended in default, or perhaps even were destined to fail; and (2) why did creditors and investors who ultimately provided the capital for these loans fail to properly assess their risk? The first question raises issues of loan origination. In terms of regulation, it begs a follow-up inquiry about how residential mortgage lenders were able to sell such loans in the first place. The second question implicates a somewhat distinct set of actors, especially in the secondary financing markets.[4] This Article focuses on the first question—issues of loan origination and the consumer protection laws applicable to those transactions. The Article discusses whether a stronger focus on consumer protection enforcement actions in public regulation of the residential mortgage market may have prevented the mass origination of subprime mortgage loans that defaulted at historic levels.[5]

While there clearly is a relationship between the secondary market actors and consumer protection concerns in loan origination,[6] consumer protection laws naturally focus on loan

4. *See, e.g.*, Chris L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2255-63 (2007) (describing inadequacy of current consumer protection laws in providing recourse against lending abuses with securitized financing).

5. This Article focuses on "subprime lending," although in the period from 2004 through 2006 many of the same issues arose in the origination of "Alt-A" loans, which consists of loans of less than prime quality or that contain higher risk features, such as negative amortization. U.S. GOV'T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 24 (2009), *available at* http://www.gao.gov/new.items/d09216.pdf [hereinafter GAO REPORT].

6. This relationship between consumer protection in origination and secondary market financing has been analyzed with commendable brilliance by Professors Chris Peterson, Pat McCoy, and Kathleen Engel. These commentators advocated imposing assignee liability for problems in origination on secondary market actors to make them account for consumer protection concerns when funding mortgage loans. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory*

origination—the part of the lending process in which the homeowner is involved directly. Consumer protection laws applicable to mortgage financing apply almost entirely to loan origination.[7]

A. *Consumer Protection and Mortgage Lending*

Consumer protection laws governing mortgage loan origination can be grouped into three categories: (1) disclosure requirements; (2) substantive regulation of loan terms; and (3) a broad prohibition on unfair and deceptive acts. Restrictions on mortgage lending in each of these areas exist at both the federal and state level. These laws also are a mix of generally applicable laws and those that govern only mortgage lending.

1. Disclosure Requirements

The primary federal laws governing consumer finance lending mostly rely on mandated disclosure of information to the consumer about the transaction.[8] The Truth in Lending Act ("TILA") has detailed disclosure requirements for "closed end" credit transactions, which would include the vast majority of first-lien mortgage loans.[9] The lender must provide a standardized disclosure form that reveals the cost of credit in the form of an "annual percentage rate."[10] Four other amounts,

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Lending, 75 FORDHAM L. REV. 2039 (2007); Peterson, *supra* note 4. *See also* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1337-57 (2002) (calling for a suitability standard for subprime loans).

7. The Truth in Lending Act ("TILA") imposes obligations on a creditor at the time a loan is originated through disclosure requirements. 15 U.S.C. §§ 1602(f), 1637a, 1638 (2006). HOEPA prohibits certain terms for high-cost loans. *Id.* § 1639. The Real Estate Settlement Procedures Act ("RESPA") also regulates loans at the origination stage through disclosure requirements and a prohibition on unearned fees and kickbacks. 12 U.S.C. §§ 2603, 2604, 2607. RESPA additionally regulates loan servicing and escrow account administration. *Id.* § 2605.

8. *See, e.g.*, Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth and Nothing But the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 187 (2008) ("Today, the consumer credit marketplace is governed almost exclusively by disclosure rules.").

9. 15 U.S.C. § 1638.

10. *Id.* § 1638(a)(4); 12 C.F.R. §§ 226.17, 226.18(e) (2009).

such as "the total of payments," must be prominently disclosed.[11] Numerous other items, such as whether the loan contains a prepayment penalty, can be disclosed less prominently on the same form.[12]

Also encompassed within TILA is a separate set of disclosures for high cost mortgage refinancing loans enacted with the Home Ownership Equity Protection Act ("HOEPA").[13] HOEPA applies only to mortgage loans that exceed certain cost or annual percentage rate "trigger" amounts.[14] Until recent amendments, these amounts were set by regulation at a very high level that excluded even the usual subprime mortgage loan.[15] HOEPA requires a special notice that warns the homeowner that "[y]ou could lose your home, and any money you have put into it, if you do not meet your obligations under the loan."[16] These disclosures must be given to the homeowner three business days prior to the closing on the refinance loan.[17]

Mortgage loan disclosures also are required by federal law under the Real Estate Settlement Procedures Act ("RESPA").[18] A "good faith disclosure" listing the costs that will be incurred

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11. 15 U.S.C. § 1638(a); 12 C.F.R. § 226.18.

12. 15 U.S.C. § 1638(b)(1); 12 C.F.R. § 226.17(a).

13. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160, 2191-94 (1994) (codified as amended at 15 U.S.C. § 1639). *See also* 12 C.F.R. §§ 226.31, 226.32.

14. 12 C.F.R. § 226.32(a).

15. *See* Truth in Lending, 73 Fed. Reg. 44,522, 44,527 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) ("Consumer advocates and some state officials stated that HOEPA is generally effective in preventing abusive terms in loans subject to the HOEPA price triggers. They noted, however, that very few loans are made with rates or fees at or above the HOEPA triggers . . . ."); *Id.* at 44,536 ([T]he Board has concluded that [a threshold of 1.5 percentage points above the average prime offer rate for first lien loans and 3.5 percentage points for second lien loans] should cover the subprime market and generally exclude the prime market . . . ."). *See also* Stephen Labaton, *Lenders Fight Stricter Rules on Mortgages*, N.Y. TIMES, Apr. 28, 2008, at A1 (noting that the HOEPA trigger of 8% above the prevailing rates on Treasury securities only applied to 1% of all mortgages).

16. 15 U.S.C. § 1639(a)(1)(B).

17. *Id.* §§ 1639(a)(1)(B), (b)(1); 12 C.F.R. §§ 226.31(c)(1), 226.32(c)(1). With the important exception of the right to rescind a mortgage refinancing loan, the remedies for violation of TILA disclosure requirements are somewhat limited in practice. *See* 15 U.S.C. §§ 1640-1641. As this Article focuses on public enforcement issues, the private right of action for violation of consumer protection laws is not relevant to our inquiry.

18. 12 U.S.C. §§ 2603, 2604.

by the consumer in originating the mortgage must be given to the consumer within three days of the application for the mortgage loan.[19] RESPA and various state law requirements impose other disclosure obligations on mortgage lenders that add more weight (literally) to the unmanageable and unreadable collection of documents that constitute a typical residential mortgage loan closing.[20]

2. Restrictions on the Terms of Mortgage Loans

Less prominent in the mortgage lending regulatory scheme are substantive restrictions on the costs and terms of residential mortgage loans.[21] No federal law substantially restricts the terms of most residential mortgage lending. The primary exception to this light regulatory touch on mortgage loan terms are certain requirements that apply to the limited set of mortgage loans regulated under HOEPA.[22] HOEPA is the only federal law that restricts the substantive terms of residential mortgage loans in the United States regardless of the state in which the loan is originated or the licensing status of the lender. HOEPA loans cannot contain negative amortization terms or most prepayment penalties.[23]

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19. 12 U.S.C. §§ 2604(c)-(d). RESPA also prohibits "kickbacks" between and among lenders and mortgage settlement service providers, such as appraisers or title insurers. 12 U.S.C. § 2607. These provisions are substantially eviscerated, however, by allowing affiliates to escape this restriction through the provision of a disclosure at closing. 12 U.S.C. § 2607(c). Public enforcement of the limited kickback prohibition remaining after the exclusion of affiliates is notoriously weak. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, ACTIONS NEEDED TO IMPROVE OVERSIGHT OF THE TITLE INDUSTRY AND BETTER PROTECT CONSUMERS (2007), *available at* http://www.gao.gov/new.items/d07401.pdf.

20. 12 U.S.C. §§ 2603-2604. The Office of the Comptroller of the Currency called for simplifying and streamlining consumer disclosures in 2005, stating that: "consumers today receive disclosures so voluminous and so technical that many simply do not read them – or when they do, do not understand them." *Consideration of Regulatory Relief Proposals: Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 20 (2005) (statement of Julie Williams, Acting Comptroller of the Currency).

21. *See* Renuart & Thompson, *supra* note 8.

22. 15 U.S.C. §§ 1639(c)-(i); 12 C.F.R. § 226.32(d).

23. 15 U.S.C. §§ 1639(c), (f); 12 C.F.R. §§ 226.32(d)(2), (d)(6)-(7). Reverse mortgages, which are typically sold to elderly homeowners, also are subject to substantive loan-term restrictions, 12 C.F.R. § 226.33, although this type of

State laws, on the other hand, often provide important limits on the costs of mortgage loans. Several states, such as Iowa, prohibit or restrict the imposition of prepayment penalties on mortgage loans.[24] Various state laws also limit the amount of finance charges, late fees, or provide loan terms at a rate higher than that for which the borrower qualifies.[25] The type of loan terms regulated and the limits placed on those loan terms vary widely under state law.

3. Unfair and Deceptive Acts and Practice Regulation

Although not specifically related to mortgage lending or even consumer finance transactions, an important part of the public regulatory scheme in the development of the subprime mortgage lending market is statutory fraud laws, often referred to as unfair and deceptive acts and practices laws, or simply "UDAP" laws.[26] UDAP laws have a different character than either disclosure requirements or substantive loan term restrictions. Consumer finance disclosures or loan term restrictions provide generally objective, if often complex, compliance standards. A public regulator can create a checklist for a compliance program relying almost exclusively on the documents in the loan file.[27] Whether the TILA disclosure is in the file and properly completed, or whether the loan contains a permissible prepayment penalty, are questions that usually will have a clear answer discernible on examination of the loan documents.

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loan is of little consequence to the story at issue here.

24. *See, e.g.*, IOWA CODE § 535.9 (2006).

25. *See, e.g.*, MINN. STAT. § 58.13(a)(25) (2008) (prohibiting "churning" or putting a borrower into a loan that does not provide a tangible net benefit); *Id.* § 58.137 (limiting fees to 5% of loan amount); GA. CODE ANN. § 7-6A-3(3) (2003) (limiting the circumstances in which a late fee may be charged); N.C. GEN. STAT. § 24-10.1 (1993) (limiting the amount of late fees).

26. *See, e.g.*, Mark E. Budnitz, *The Federalization and Privatization of Public Consumer Protection Law in the United States: Their Effect on Litigation and Enforcement*, 24 GA. ST. U. L. REV. 663, 674 (2008).

27. *See, e.g.*, Rule to Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs, 73 Fed. Reg. 68,204, 68,243 (Nov. 17, 2008) (to be codified at 24 C.F.R. pt. 3500, app. A) (line-by-line instructions for completing the settlement statements that lenders must disclose to borrowers pursuant to RESPA).

On the other hand, determining a violation of UDAP laws requires a public enforcement agency to ask questions such as: did the homeowner understand the loan terms; were the representations about loan terms in the sale of the loan consistent with the actual loan product; and did the homeowner actually receive the benefits of the loan as indicated in the loan documents. Determining a violation of UDAP laws likely requires (1) an examination of the loan file; (2) interviews with the homeowners obtaining the loan and the employees or agents who arranged the loan; (3) a review of any marketing materials used in connection with the loan; and (4) any other relevant information beyond the bounds of the loan file.[28] Even loans that the consumer understood may violate the requirement against "unfair" practices in the Federal Trade Commission ("FTC") Act[29] and most state UDAP laws.[30]

B. *Financial Institution Regulatory Structure and UDAP Enforcement*

The financial regulatory system in the United States is a multi-headed beast, spanning federal and state government. The most striking feature of the financial regulatory system is its fragmentation. Reports by the United States Government Accountability Office and the Congressional Oversight Panel, appointed under the Emergency Economic Stabilization Act,[31] examine this system in detail,[32] but such analysis is beyond the purpose of this Article. Instead, I will focus here on a few key points relevant for understanding what did (or, more importantly, did not) happen in the regulation of the subprime

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28. *Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. (2009) (testimony of Lisa Madigan, Illinois Attorney Gen.) [hereinafter Madigan 2009 testimony], *available at* http://www.illinoisattorneygeneral.gov/consumers/Testimony_before_Rep_Frank.pdf, at 2-6.

29. 15 U.S.C. §§ 41-51 (2006).

30. *See, e.g.*, N.Y. GEN. BUS. LAW § 349 (2009).

31. 12 U.S.C.A. § 5233(a) (West 2009 Cumulative Annual Pocket Part).

32. *See generally* GAO REPORT, *supra* note 5; CONG. OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM (2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf [hereinafter COP REPORT].

mortgage market.

Especially as to mortgage financing, the regulatory system divides into three general categories of regulation—depository institutions (mostly banks and thrifts), securities, and non-banks. Within each of these categories, multiple federal and state regulators operate with different authorities and purposes. Because this Article focuses on the failure of the regulatory structure to correct problems in loan origination, I will describe only the depository and non-bank regulatory schemes. The third part of this subsection sketches the reach of state attorneys general and the Federal Trade Commission in UDAP enforcement.

1. Depository Institution Regulation

Depository institution regulation occurs at both the state and federal levels.[33] There are three types of depository institutions—banks, thrifts, and credit unions.[34] Each of these types of institutions has its own regulator at the federal or state level.[35] National banks are regulated by the Office of the Comptroller of the Currency ("OCC").[36] Thrifts, or savings banks, arose from the ashes of the collapsed savings and loan regulatory system in the 1980s and are regulated at the federal level by the Office of Thrift Supervision ("OTS").[37] Federal credit unions are regulated by the National Credit Union Administration ("NCUA").[38] States also typically have an analogous depository institution regulatory structure for each of these forms, usually conducted through a regulator called the Department of Financial Institutions ("DFI").[39] The

33. *See, e.g.*, Bar-Gill & Warren, *supra* note 2, at 79-80.

34. *See, e.g.*, *id.*

35. *See, e.g.*, *id.*

36. Office of the Comptroller of the Currency, About the OCC, http://www.occ.treas.gov/aboutocc.htm (last visited May 29, 2009).

37. Office of Thrift Supervision, History, http://www.ots.treas.gov/?p=History (last visited May 29, 2009).

38. National Credit Union Administration, About NCUA, http://www.ncua.gov/About/Default.aspx (last visited May 29, 2009).

39. *See, e.g.*, California Department of Financial Institutions, http://www.dfi.ca.gov/ (last visited May 31, 2009); Tennessee Department of Financial Institutions, http://www.state.tn.us/tdfi (last visited Sept. 22,

primary function of each of these regulators is to ensure that the depository institutions are run in a safe and sound manner so that depositors, and ultimately the federal deposit insurance system, are protected from irresponsible business practices.[40]

A depository institution draws its operating authority from a charter authorized by the specific federal or state law under which each regulator operates, and the institution pays assessments to that regulator.[41] There are two unique aspects to this regulatory system. First, financial institutions essentially select their regulator by selecting their type of charter.[42] Second, the budget for the regulator is drawn primarily from charter fees paid by the regulated entities.[43] The largest bank regulator, the OCC, typically derives more than 90% of its fee income from charter fees paid by the entities that it regulates.[44] Regulatory agencies in some other fields assess fees, but the depository institution regulatory system is unique in that it allows the regulated entity to select its own regulator while simultaneously asking the regulator to rely on assessments levied on those same regulated entities as its primary source of operating funds.[45] The predictable result of this arrangement is that regulators engage in "charter competition" for depository institutions.[46] Financial institutions can and do switch from one type of charter to another, and thus from one regulator to another, when the institution determines that such a switch in charter is in its own self-interest.[47]

The Federal Reserve Board ("FRB") has a role with

2009); Wisconsin Department of Financial Institutions, http://www.wdfi.org/ (last visited May 31, 2009).

40. *See* Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 73 (2005).

41. *See, e.g.*, Bar-Gill & Warren, *supra* note 2, at 79-80.

42. *See, e.g.*, *id.*

43. GAO REPORT, *supra* note 5, at 59.

44. Amanda Quester & Kathleen Keest, *Looking Ahead After* Watters v. Wachovia Bank*: Challenges for Lower Courts, Congress, and the Comptroller of the Currency*, 27 REV. BANKING & FIN. L. 187, 200 (2007).

45. *See, e.g.*, 47 U.S.C. § 159 (2006) (Federal Communications Commission fees).

46. DAN IMMERGLUCK, FORECLOSED: HIGH-RISK LENDING, DEREGULATION AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET 177-78 (2009).

47. *Id.*

depository institutions, regardless of the primary regulator.[48] The FRB plays a critical role in mortgage lending regulation through its authority under TILA and HOEPA to enact regulations that apply nationwide to all mortgage loans—rules that must be complied with by depository institutions and non-bank institutions alike.[49] No other regulatory entity possesses this type of critical rule-making authority. The FRB's authority under HOEPA is particularly important with subprime mortgage lending because it allows the promulgation of substantive rules directed at high-cost lending.[50] The FRB even has the ability to promulgate rules changing the "trigger" amounts that define which loans are deemed sufficiently high-cost to be eligible for inclusion under HOEPA's protections.[51]

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48. *Mortgage Lending Reform: A Comprehensive Review of the American Mortgage System: Before the H. Subcomm. on Financial Institutions and Consumer Credit of the H. Financial Servs. Comm.*, 111th Cong. (2009) (written statement of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System) [hereinafter Braunstein Testimony], *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/braunstein031109.pdf, at 2 ("The Federal Reserve has primary rulewriting responsibility for many consumer protection laws, including the Truth in Lending Act and the Home Ownership and Equity Protection Act . . . . [T]he Board's new rules apply to all mortgage lenders, not just depository institutions supervised by the federal banking and thrift agencies.").

49. *See* 15 U.S.C. § 1604(a) ("The Board shall prescribe regulations to carry out the purposes of this subchapter."); *id.* § 1639(*l*)(2) ("The Board, by regulation or order, shall prohibit acts or practices in connection with (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.").

50. Truth in Lending, 73 Fed. Reg. 44,522, 44,529 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) ("Congress set minimum standards for HOEPA loans. The Board is authorized to strengthen those standards for HOEPA loans when the Board finds practices unfair, deceptive, or abusive."); Braunstein Testimony, *supra* note 48, at 152-54. In fact, the Federal Reserve Board finally implemented a program of supervision for nonbank subsidiaries of bank holding companies in September 2009. Div. of Consumer & Cmty. Affairs, Fed. Reserve Sys., Consumer Compliance Supervision Policy for Nonbank Subsidiaries of Bank Holding Companies and Foreign Banking Organizations, Consumer Affairs Letter 09-8 (Sept. 14, 2009), *available at* http://www.federalreserve.gov/boarddocs/caletters/2009/0908/caltr0908.htm.

51. 15 U.S.C. § 1602(aa)(2) (2006).

2. Regulation of Non-Bank Lenders

A striking feature of the growth in subprime mortgage origination was the rise of lending channels outside the depository institution, often called non-bank lenders.[52] There is very limited federal oversight of most of these non-bank mortgage lenders. They must comply with the general disclosure requirements in TILA and RESPA, as well as other limited federal law governing all mortgage-lending activity, but there is no federal regulator supervising these entities.[53] Instead, non-bank lenders are regulated by state DFIs.[54] As noted in the U.S. government reports on financial institution regulation, non-bank lenders were not supervised for safety and soundness.[55]

An important exception to state supervision of non-bank lenders is when these entities are operating subsidiaries of a national bank. The OCC has taken the position that non-bank operating subsidiaries of national banks are subject only to regulation by the OCC and that regulation of such entities by state DFIs was preempted by the National Bank Act.[56] In *Watters v. Wachovia Bank, N.A.*, a divided United States Supreme Court upheld the OCC's expansive view of its

52. *See generally* Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 536-41 (2005) (discussing the rise of non-bank mortgage lenders making high-cost subprime loans).

53. *See generally* Braunstein Testimony, *supra* note 48.

54. Peterson, *supra* note 40, at 84-86. Because these lenders were not depository institutions, they were not subject to safety and soundness examinations. A critical recommendation of the recent reports on the financial institution regulatory system has been that the public sector should ensure that any entity making mortgage loans is examined for safety soundness. As we have discovered in the last few years, failure of these loans ultimately resulted in consequence to the public.

55. U.S. DEP'T OF TREASURY & U.S. DEP'T OF HOUSING & URBAN DEV., HUD – TREASURY REPORT, at 18 (2000). *See also* Engel & McCoy, *A Tale of Three Markets*, *supra* note 6, at 1291-92.

56. *See, e.g.*, Peterson, *supra* note 40, at 76-85 (discussing the OCC's actions, including regulations, litigation, and asserting preemption of state laws regulating the mortgage of lending activities non-bank subsidiaries of national banks, and noting that "[e]ven the federal government itself found in a GAO audit that non-bank mortgage lending subsidiaries owned by bank holding companies have received light scrutiny by federal regulators").

preemptive authority in this respect.[57]

3. UDAP Enforcement

Federal UDAP law is enforced primarily by the FTC.[58] Additionally, UDAP laws, sometimes modeled on the FTC Act itself, exist in every state.[59] State attorneys general typically have the authority to enforce state UDAP laws as well.[60] Both the FTC and state attorneys general have extraordinarily broad scope in the type of conduct under their purview.[61] Telemarketing, automobile sales, credit repair organizations, and countless other marketplace transactions are regularly subject to UDAP actions by the FTC or the state attorneys general.[62] Mortgage lending is just one of the many areas in

57. Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007).

58. Bar-Gill & Warren, *supra* note 2, at 95-97 (discussing the mission and enforcement authority of the FTC).

59. Budnitz, *supra* note 26, at 674.

60. *Id.* at 676-77.

61. The FTC is "empowered and directed to prevent . . . unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce." 15 U.S.C. § 45(a)(2) (2006). State mini-FTC statutes similarly prohibit unfair and deceptive acts or practices. Budnitz, *supra* note 26, at 674.

62. *See, e.g.*, Federal Trade Commission, Commission Actions for April 2009, http://www.ftc.gov/os/2009/04/index.shtm (last visited Sept. 22, 2009) (listing FTC enforcement actions involving anticompetitive or unfair and deceptive practices in the areas of telephone service, breakfast cereal, cable and satellite television, herbal remedies, and others); Press Release, Iowa Department of Justice, Office of the Attorney General, "Get-Rich-Quick" Scheme Banned from Iowa (May 8, 2009), *available at* http://www.iowa.gov/government/ag/latest_news/releases/may_2009/World_Wealth.html (discussing an action against a company using misleading advertisements to market "money-making opportunities"); Press Release, State of New York, Office of the Attorney General, Attorney General Cuomo Obtains Court Order Against Poughkeepsie Chevrolet for Fraudulent Sales Practices (Mar. 24, 2009), *available at* http://www.oag.state.ny.us/media_center/2009/mar/mar24a_09.html (discussing action against car dealership for fraudulent and deceptive acts in connection with the sale of automobiles); Press Release, State of Minnesota, Office of the Attorney General, Minnesota Attorney General Lori Swanson Files Suit Against Source Lending Corporation Over Abusive Predatory Mortgage Lending Practices (Aug. 14, 2008), *available at* http://www.ag.state.mn.us/Consumer/PressRelease/080814Mortgage.asp (discussing action against a mortgage broker for using "bait-and-switch" tactics).

which these agencies operate.

Both the FTC and state attorneys general have restrictions on their enforcement authority. The Federal Trade Commission is restricted from taking actions against banks.[63] The OCC claims UDAP authority over the conduct of national banks.[64] State UDAP laws contain a variety of restrictions on public enforcement, but these limits vary widely among the states. A few states do not allow their attorneys general to bring actions against lenders.[65] Some other states prevent attorney general actions if the target of the action is an entity regulated by another state or federal agency.[66]

II. How the Various Regulators Performed

The question at issue here is how these various public regulators employed their resources and authority to identify and regulate the abuses in subprime lending before the mortgage crisis became apparent. The answer, in short, is that the only public agencies that systematically attempted to attack problems in subprime mortgage lending were a few state attorneys general allied with a few state financial regulators who brought actions alleging UDAP violations.

A. *State Consumer Protection Actions Identified Lending Weaknesses*

Beginning in the late 1990s, a small group of state attorneys general, joined by a few state financial regulators, began to identify consumer protection problems with subprime mortgage lending and brought collective actions, known as multi-state enforcement actions, against these lenders.[67]

63. 15 U.S.C. § 45(a)(2) (2006).

64. Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans, OCC Advisory Letter 2003-3, at 5, *available at* http://www.occ.treas.gov/ftp/advisory/2003-3.pdf.

65. Peterson, *supra* note 40, at 50.

66. *See, e.g.*, WASH. REV. CODE § 19.86.170 (2009).

67. Prior to joining the faculty of the University of Minnesota Law School in 2005, the author was an Assistant Attorney General in the Minnesota Attorney General's Office and was personally involved in the leadership of all of the enforcement actions described herein.

Several state attorneys general and regulators initiated actions against First Alliance Mortgage Company ("FAMCO") beginning in 1998.[68]

FAMCO was making extraordinarily high cost loans to borrowers, with fees regularly exceeding 20% of the principal amount in a large number of cases.[69] The vast majority of borrowers were sold "teaser rate" adjustable rate mortgages that would increase at an average of more than 2%, even if rates remained stable.[70] Most borrowers had no idea about these high costs and adjustable interest rates.[71]

The deceptive practices engaged in by FAMCO were orchestrated through an intensive and highly structured sales approach, centered on a sales script the company called "The Track."[72] The Track sales presentation involved building trust between the loan officer and the homeowner and then confusing the homeowner about the extraordinary loan terms.[73] Loan officers, who were typically former automobile salespeople, were sent to FAMCO's California headquarters to train for a month in delivering the sales talk.[74] FAMCO filed

68. *Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market: Joint Hearing Before the Subcomm. on Financial Institutions and Consumer Credit and the Subcomm. on Housing and Community Opportunity*, 108th Cong. (2004) (written testimony of Pamela Kogut, Massachusetts Assistant Attorney Gen.) [hereinafter Kogut Testimony], *available at* http://www.house.gov/financialservices/media/pdf/062304pk.pdf (describing the actions taken by state attorneys general against FAMCO).

69. *Id.* at 3 (stating that in Massachusetts, 35% of loan fees exceeded 20% and 73% exceeded 10%). *See also* Memorandum in Support of the State's Motion for a Temporary Injunction at 4, State v. First Alliance Mortgage Co., No. C9-98-11416 (Minn. Dist. Ct. Nov. 20, 1998) (supporting a temporary injunction, stating that the average loan fee in Ramsey County was almost 22%).

70. Kogut Testimony, *supra* note 68, at 4 (majority of FAMCO loans were teaser rate ARMs); Memorandum in Support of the State's Motion for a Temporary Injunction, *supra* note 69, at 5 (stating that all of the Ramsey County borrowers had ARM loans with teaser rates of more than 3% on average).

71. Memorandum in Support of the State's Motion for a Temporary Injunction, *supra* note 69, at 5.

72. Kogut Testimony, *supra* note 68, at 4-5.

73. *Id.* *See also* Memorandum in Support of the State's Motion for a Temporary Injunction, *supra* note 69, at 5-10.

74. Memorandum in Support of the State's Motion for a Temporary Injunction, *supra* note 69, at 3.

for bankruptcy in 2000 in the wake of a joint *New York Times* and ABC-TV story exposing its lending practices and the state lawsuits.[75]

The FAMCO litigation was followed by two other multi-state actions, initiated by state consumer protection regulators, alleging UDAP violations by the largest subprime lenders at the time. In 2002, the states reached a settlement with Household, Inc. ("Household"), then the largest subprime mortgage lender in the United States.[76] The settlement included $525 million in restitution to homeowners and varying payments to the states.[77] Perhaps more importantly, the settlement provided for extensive injunctive relief that could serve as a roadmap for the problems that lay ahead in the surging subprime mortgage market.[78] The injunction limited Household's loan fees, required that loans create a "net tangible benefit" for borrowers and imposed other regulations on Household's mortgage origination practices.[79]

In 2004, a similar group of states began investigating Ameriquest Mortgage Corporation ("Ameriquest"), a company that had become the nation's largest subprime mortgage lender and would become synonymous with unfair and imprudent subprime mortgage lending.[80] The states eventually settled the case in 2006 for $325 million in restitution to consumers.[81] Again, the states' settlement imposed an extensive injunction on the company's operations and loan volume at Ameriquest promptly fell.[82]

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75. Diana B. Henriques & Lowell Bergman, *Mortgaged Lives: Profiting From Fine Print With Wall Street's Help*, N.Y. TIMES, Mar. 15, 2000, at A1; Diana B. Henriques, *Troubled Lender Seeks Protection*, N.Y. TIMES, Mar. 24, 2000, at A1.

76. *See, e.g.*, State v. Household Int'l, Inc., No. C5-02-12133 (Minn. Dist. Ct. Dec. 16, 2002) (example of settlement agreement filed in all 50 states).

77. *Id.* at 7-11.

78. *Id.* at 11-22.

79. *Id.* at 19.

80. *See, e.g.*, Kristin Downey, *Mortgage Lender Settles Lawsuit*, WASH. POST, Jan. 24, 2006, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/01/23/AR2006012301523.html.

81. *Id.* *See also* State v. Ameriquest Mortgage Co., No. C0-06-2618, at *9-13 (Minn. Dist. Ct. Mar. 21, 2006) (example of settlement agreement filed in all 50 states) (on file with Pace Law Review).

82. *Ameriquest Mortgage Co.*, at *13-37 (No. C0-06-2618).

These state consumer protection actions were coincident with the explosion and the development of the subprime mortgage industry. At the time the states initiated their actions against FAMCO in 1998, subprime mortgage lending had increased dramatically, both in terms of the volume of loans and the percentage of new market originations.[83] Subprime mortgage volume stabilized at about $200 billion from 1998 through 2002.[84]

The Ameriquest investigation and settlement occurred at precisely the moment the subprime mortgage market had begun its final surge that would ultimately overwhelm global financial markets. Subprime mortgage lending jumped, starting in 2003, and then exploded in the period between 2004 and 2006.[85] The volume of subprime mortgage loans peaked at about $650 billion in 2006, an astounding rise from the volume level of about $200 billion in 2002.[86] The conduct alleged to violate state laws in the Ameriquest case should sound familiar to anyone who has tracked the mortgage meltdown—falsified stated income loans, inflated appraisals, inadequately understood teaser rates on adjustable mortgages, and other conduct typical of this latter period of explosive growth in the subprime market.[87] In other words, as the subprime market exploded and the deceptive and imprudent lending practices evolved between 1998 and 2006, the state UDAP actions were an excellent bellwether and predictor of the problems with this lending.

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83. ELLEN SCHLOMEMER, WEI LI, KEITH ERNST & KATHLEEN KEEST, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET & THEIR COST TO HOMEOWNERS 7 (2006), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf.

84. *Id.*

85. FED. RESERVE BD. OF SAN FRANCISCO, THE SUBPRIME MORTGAGE MARKET: NATIONAL AND TWELFTH DISTRICT DEVELOPMENTS 8 (2007), *available at* http://www.frbsf.org/publications/federalreserve/annual/2007/2007annualreport.pdf.

86. *Id.*

87. *See* Madigan 2009 testimony, *supra* note 30, at 3-4. *See also* State v. Ameriquest Mortgage Co., No. C0-06-2618 (Minn. Dist. Ct. Mar. 21, 2006); Press Release, State of Washington Attorney General's Office, Washington Homeowners to Receive Millions in Ameriquest Settlement, (Jan. 23, 2006), *available at* http://www.atg.wa.gov/pressrelease.aspx?&id=16354.

B. *Failure of the Financial Institution Regulatory System to Comprehend the Threat of Subprime Mortgage Lending*

The actions of safety and soundness regulators during this period showed a different pattern. There is no shortage of blame to be laid on financial institution regulators for their failure to detect and remedy the sales and lending practices that led to the explosion of home foreclosures and the eventual implosion in residential mortgage lending. State financial institution regulators, with fewer resources and substantially less regulatory power than federal regulators, were the primary regulators of non-bank mortgage originators who were not subsidiaries of federally chartered institutions.[88] Although these regulators joined with the state attorneys general in the multi-state actions against major subprime lenders, they were unable to control the lending practices of these entities sufficiently to prevent the problems that occurred in the origination of residential mortgages.[89]

Some of the most spectacular failures in the subprime mortgage market were federally regulated institutions. The OTS, in particular, has been sharply criticized for its lax regulation of mortgage lending.[90] In 2007, the nation's largest mortgage lender, Countrywide Financial Corp. ("Countrywide"), switched its charter from the OCC to the OTS amid circumstances suggesting the worst sort of shopping for a weak regulator.[91] Before its collapse, IndyMac was supervised by the OTS and originated extraordinary volumes of problem loans with little obstruction from the OTS.[92] Likewise, OCC regulated financial institutions engaged in loan origination or invested in loans originated by mortgage brokers that led to massive losses, such as First National Bank of Nevada and its

88. GAO REPORT, *supra* note 5, at 15.

89. *See* Press Release, State of Washington Attorney General's Office, *supra* note 87.

90. *See, e.g.*, Binyamin Appelbaum & Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer*, WASH. POST, Nov. 23, 2008; Editorial, *Our View on the Credit Crisis: A System That Invited Bankers to Make Bad Loans*, USA TODAY, Jan. 5, 2009.

91. Appelbaum & Nakashima, *supra* note 90.

92. *Id.*

predecessor banks.[93]

As to substantive mortgage regulations, the federal regulators have substantial formal authority and the authority to issue "guidance" to their institutions, but until the very end of the surge of subprime lending, these regulators did little to limit bank investment in, or origination of, problem loans.[94] In 1999, and again in 2006, the federal banking agencies issued guidance on subprime and then "nontraditional" mortgage products, but they brushed aside consumer advocate warnings about these products and refused to adopt substantial limits on such lending, either by formal or informal action.[95]

In fact, a primary contribution of both the OCC and the OTS to substantive regulation of mortgage terms was the issuance of sweeping regulations preempting state laws that limited unfair mortgage loan terms for homeowners.[96] For example, after Georgia passed its own anti-predatory lending law with restrictions that applied even to secondary market assignees of mortgage laws, both the OTS and the OCC acted swiftly to preempt the Georgia law.[97]

The OCC also actively worked to suppress consumer protection investigation of, and enforcement actions against, their regulated entities by state attorneys general, promulgating rules claiming for itself the exclusive authority to investigate and enforce violations of state consumer protection laws, thus purporting to effectively bar state enforcement agencies from enforcing their own state laws against a national bank even when those laws were not preempted.[98] The United State Supreme Court recently found that this rule was so "bizarre" and contrary to the text and history of the National Bank Act that it overturned the regulation, even while giving

93. David Enrich & Damian Paletta, *Two Bank Failures Hint At Oversight Woes*, ARIZ. DAILY STAR, Oct. 5, 2008.

94. IMMERGLUCK, *supra* note 46, at 178-81.

95. Interagency Guidance on Nontraditional Mortgage Risk, 71 Fed. Reg. 58,609 (Oct. 4, 2006); Interagency Guidance on Subprime Lending (Mar. 1, 1999), http://www.fdic.gov/news/news/financial/1999/FIL9920a.html. *See also* IMMERGLUCK, *supra* note 46, at 181-82.

96. COP REPORT, *supra* note 32, at 52.

97. IMMERGLUCK, *supra* note 46, at 178.

98. 12 C.F.R. § 7.4000 (2009).

deference under the *Chevron* Doctrine.[99] The OCC also regularly engaged in filing amicus briefs and intervening in cases on behalf of its regulated entities and against state UDAP enforcement or consumers seeking redress from a national bank.[100] John Hawke, the former Comptroller of the Currency, publicly defended the OCC's preemption of state law and state regulators to persuade financial institutions to switch from a state charter to a national bank charter, stating that he was "not the least bit ashamed to promote" preemption as "one of the advantages of a national charter."[101]

While obstructing state UDAP enforcement with broad assertions of preemptive authority, the OCC and the OTS failed to initiate UDAP enforcement activity in the area of mortgage lending. The OCC pursued almost no major UDAP actions involving mortgage lending during the period of abusive subprime mortgage lending.[102] The OCC has almost no record of taking public consumer enforcement actions against large banks.[103]

The FRB also took little or no action to control subprime mortgage lending. It alone has the authority, under HOEPA, to impose nationwide substantive restrictions on all high-cost residential mortgage loans.[104] Again, only after the collapse of subprime mortgage lending in 2007 did the FRB update HOEPA rules, and even then, it delayed the effective date of the rule changes until October 2009, more than a year after the promulgation of the final amendments.[105] The remarks of the FRB Directors during the subprime mortgage lending explosion make clear that it believed innovation in the mortgage lending

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99. Cuomo v. Clearinghouse Ass'n, 129 S. Ct. 2710, 2718 (2009).

100. Quester & Keest, *supra* note 44, at 199.

101. Jess Bravin & Paul Beckett, *Friendly Watchdog: Federal Regulator Often Helps Banks Fighting Consumers – Dependent on Lenders' Fees, OCC Takes Their Side Against Local, State Laws – Defending Uniform Rules*, WALL ST. J., Jan. 28, 2002, at A1.

102. Quester & Keest, *supra* note 46, at 195-96.

103. *See* Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 232 (2004).

104. *See supra* notes 49-51.

105. Truth in Lending, 73 Fed. Reg. 44,522 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226); 73 Fed. Reg. at 44,595.

market would be impeded by any serious attempt to impose substantive restrictions on high-cost mortgage lending and that expanded subprime lending was a social good.[106]

Federal regulators with a singular mission of supervising the financial institutions they chartered did little to comprehend or remedy the mortgage lending problems of the last decade and impeded the work of state legislatures and consumer protection enforcers in this area. The most prominent actions against subprime mortgage lenders were taken by state attorneys general with general UDAP authority over these lenders, but also with UDAP responsibility for a range of other industries and marketplace conduct. The following section suggests the reason for this outcome and the lessons that can be learned.

III. Creating Safer Financial Institutions by Incorporating Consumer Protection Norms

The oft-repeated phrase "no one could have predicted this crisis" is patently incorrect. If regulators were focused on the reality of the subprime mortgage lending practices that began to emerge in the late 1990s, then nothing about the collapse of that boom would have been surprising. The weakness of subprime mortgage loans, and the devastation visited upon subprime borrowers and their communities, was predictable and preventable. It is not a coincidence that state entities with a central UDAP focus were the only regulators or organizations that made substantial efforts to identify and address rampantly imprudent mortgage lending practices during the time of explosive growth in this type of lending. This result occurred even though the state attorneys general have far fewer resources devoted to the area of mortgage lending practices than federal depository institution regulators and possess far less authority to stop abusive practices by administrative order or regulation.

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106. IMMERGLUCK, *supra* note 46, at 181. *See generally* Binyamin Appelbaum, *As Subprime Lending Crisis Unfolded, Watchdog Fed Didn't Bother Barking*, WASH. POST, Sept. 27, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/09/26/AR2009092602706.html?sub=AR.

Therein lies two important lessons for the restructuring of financial institution regulation. First, the information gained from enforcing UDAP laws differs from the information gained by enforcing other types of consumer protection laws, and this type of knowledge acquired from UDAP enforcement has been undervalued by regulators. Second, it is critical to align incentives for UDAP enforcement and create an open and flexible structure for these enforcement actions against financial institutions.

A. *Building UDAP Norms in Financial Institution Regulation*

Regulator understanding of potential problems is determined in part by the type of information it receives, which informs the knowledge of the regulator about the industry and businesses it supervises. Financial institution regulators would benefit by gleaning knowledge from effective UDAP enforcement.

1. UDAP Enforcement Helps Regulators Gain Understanding

Federal financial institution regulators have viewed consumer protection as a "compliance" problem, which often has been short-hand for making sure that the regulated entity gave the consumer required disclosures. These regulators periodically conduct examinations of their regulated institutions. A search of the OCC website for its instructions to bank examiners on consumer protection issues yields mostly detailed manuals for ensuring that the institution complied with various federal disclosure laws.[107]

Compliance examinations focus on reviewing data and transaction testing to determine performance and efficient market functioning, depending on the regulator.[108] Federal

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107. *See generally* OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK – CONSUMER COMPLIANCE (1999), *available at* http://www.occ.treas.gov/handbook/compliance.htm.

108. *See, e.g.*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK, at 1-3 (1996), *available at* http://www.occ.treas.gov/handbook/overview.pdf.

financial institution regulators generally rely on the regulated entity itself to report fraud to the regulator.[109] Consumer protection compliance work of this sort is not of great importance to federal financial institution regulators, in any case, because safety and soundness concerns predominate.[110]

Public actions for violations of UDAP laws, on the other hand, typically arise from observations and reflected experience of individuals who work closely with consumers who are in distress. In the case of subprime lending, state attorneys general and other consumer protection regulators received complaints showing a pattern of mortgage loans whose terms revealed a disconnection between cost and risk, and in which homeowners repeatedly expressed misperception of the actual terms of the mortgage. State attorneys general receive and evaluate large volumes of complaints by borrowers, and have expertise in analyzing such data for patterns of conduct.[111] The more aggressive agencies also have close ties to credit counselors, legal aid organizations, and other public interest organizations, which reflect the experience of an even larger number of borrowers.[112] In other words, consumer protection agencies gather and focus on data that is based on the experience and perceptions of the credit users.

Furthermore, UDAP regulators often have a bias in favor of believing consumers whose experience is not necessarily consistent with the written documents purposed by the seller that memorialize the transaction. In the case of FAMCO, for example, the state actions did not allege any breach of contract or non-compliance with required disclosures, but rather focused

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109. *See, e.g.*, *Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Before the H. Comm. on Financial Servs.*, 111th Cong. (2009) (written statement of Elizabeth Duke, Member, Federal Reserve Board of Governors), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/frb_-_duke.pdf.

110. Marilyn Cane, *Non-Broker Brokers and Other Anomalies in the Regulation of Financial Services*, 11 HARV. J.L. & PUB. POL'Y 111, 126 (1988) (noting in the securities fraud context that "the examination of banks has its focus on bank solvency, not the detection or prevention of securities fraud"). *See also* Peterson, *supra* note 40, at 73.

111. *See* Brief for Center for Responsible Lending et al. as Amici Curiae Supporting Petitioner, Cuomo v. Clearinghouse Ass'n, 129 S. Ct. 2710 (2009) (No. 08-453), 2009 WL 556380.

112. *See* Madigan 2009 testimony, *supra* note 28, at 1, 7-8.

on the highly misleading oral sales presentation that led borrowers to enter loans that they fundamentally did not understand.[113] FAMCO was an early adopter of funding subprime lending through mortgage-backed securities.[114] In funding FAMCO ten years ago, Lehman Brothers was aware of the consumer protection concerns with FAMCO's subprime mortgage lending. A district court later found that "Lehman knew that First Alliance was engaged in fraudulent practices designed to induce consumers to obtain loans from First Alliance."[115]

Knowledge gained from UDAP enforcement has a direct bearing on financial institution safety and soundness. In the case of subprime lending and the mortgage meltdown, loan performance data in the late 1990s and early 2000s would not necessarily have suggested a substantial reason for concern, principally because housing appreciation was covering the sins apparent when looking at the problems of individual homeowners. A loan performs well for safety and soundness purposes if housing appreciation (and loose underwriting) allows a borrower to refinance from one unsustainable loan to an even more unsustainable loan, or allows that borrower to sell his or her home prior to default.[116] It is a difficult task to sort through the influences on loan performance data at the time the data is current. UDAP enforcers, however, understood that these loans were a disaster for borrowers long before it became apparent that creditors and investors holding these loans would suffer.[117]

2. Methods for Incorporating UDAP Norms in Regulation

The key to effective regulation is to bridge the gap between these two different types of knowledge. Regulators must measure the reality of what borrowers really understand about

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113. *See* Kogut Testimony, *supra* note 68, at 3-4.

114. Diana B. Henriques & Lowell Bergman, *Profiting From Fine Print With Wall Street's Help*, N.Y. TIMES, Mar. 15, 2000, at A1.

115. *In re* First Alliance Mortgage Co., 298 B.R. 652, 668 (C.D. Cal. 2003).

116. SCHLOMEMER, LI, ERNST & KEEST, *supra* note 83, at 13-14.

117. *See* Madigan 2009 testimony, *supra* note 28, at 2-6.

a loan and whether borrowers are acting in their long-run self interest, against the performance of consumer financial products. If there is a disconnect between what UDAP enforcement reveals and what review of financial performance indicates, then a financial institution regulator has strong reason to dig deeper into the operations of the regulated entity.

The starting point for creating these conditions with financial institution regulators is to increase the prominence of UDAP enforcement in the regulatory system. UDAP concerns are seen by financial institution regulators as either irrelevant to mortgage market regulation or as antithetical to creating efficient mortgage markets. Consumer complaints are too often considered either isolated occurrences or technical problems (e.g., failure to provide the correct disclosure form).[118] The OCC consumer complaint system has been described by one commentator as actually discouraging the filing of consumer complaints about national banks.[119]

Regardless of what new regulatory structures emerge from the variety of options for reform, a UDAP perspective can be brought into the core of the regulatory system. The system for accepting, evaluating, and resolving consumer complaints should be as open and user-friendly as possible. Consumer complaints should be seen as an opportunity to gain insight into the understanding of financial institution products by consumers. Financial regulators should also seek out information from individuals and organizations who work closely with borrowers and other consumers of financial institution products. Credit counselors and consumer advocacy organizations have important knowledge about how consumers are using and evaluating financial products.

While these actions can be part of almost any restructured regulator, a precondition to effectively incorporating a UDAP perspective into the regulatory system is the creation of the proper incentives for the regulator. The next subsection looks at that issue.

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118. *See* Quester & Keest, *supra* note 44, at 235-36.
119. *Id.* at 236.

B. *Structural Changes to Create UDAP Enforcement Incentives*

An obvious starting point for any structural change is the elimination of charter competition so that financial institution regulators will not have disincentives to bring UDAP actions against regulated entities free to switch to more "friendly" regulators. A second critical reform is to end preemption of state UDAP actions against regulated financial institutions and expand the FTC authority over banks.

1. *Align Incentives For UDAP Enforcement Within Depository Institution Regulation*

The current regulatory structure is riddled with conflicts of interest that make it almost inevitable that consumer protection concerns will be seen as antithetical to the core mission of the depository institution regulators. The banking regulators are structured for "charter competition."[120] Banks are allowed to decide whether to have a federal or state charter, as well as whether to have a bank or savings bank (thrift) charter.[121] Because the funding of financial institution regulators is based primarily on charter fees paid by the regulated entities, the size and prestige of the regulatory institutions—indeed their survival in some cases—is linked to the number of regulated entities under their authority.[122] The record of financial institution regulators overall has been to take the side of the regulated entities against UDAP

120. COP REPORT, *supra* note 32, at 33.

121. IMMERGLUCK, *supra* note 46, at 177-78.

122. *Id.* A related problem is the privatization of regulatory functions. The obvious example of this is the privatization of Fannie Mae in the 1960s. The effect of making these entities private has been to put consumer protection concerns in conflict with investor interests. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC: ANALYSIS OF OPTIONS FOR REVISING THE HOUSING ENTERPRISES' LONG-TERM STRUCTURES 32-34 (2009). A more subtle form of this privatization is allowing entities that serve a key function in determining the form and amount of mortgage lending to operate without regulation at all, or with minimal supervision. In some states, mortgage originators are very lightly regulated. The rating agencies, key players in the breakdown of risk management in the securitization process, were essentially unregulated. GAO REPORT, *supra* note 5, at 30-32.

enforcement by other public entities as well as actions by private consumer law attorneys.[123]

Charter competition should simply be eliminated by changing the funding method of these regulators and perhaps creating a unified regulator for all depository financial institutions. Recent reports by the U.S. government on the financial crisis have presented this issue as a possible reform to be adopted in the restructuring of the financial regulatory system.[124] Effective UDAP enforcement requires taking on the perspective of the aggrieved consumer. It is difficult to imagine a regulator taking such UDAP concerns seriously when the regulator is funded by the regulated.

2. Promote Regulatory Competition For Consumer Protection

The incentives in the current financial institution regulatory structure for UDAP enforcement, or inaction or opposition to UDAP enforcement, should be flipped and barriers to public enforcement of UDAP laws against banks should be eliminated. State attorneys general should not be precluded from bringing UDAP enforcement actions against regulated financial institutions. Such a system would make for a more efficient use of limited UDAP enforcement resources as to financial institutions and lower the cost of UDAP enforcement by entities other than depository institution regulators. In the current system, a state attorney general considering a UDAP action against a bank faces the near certainty that the bank will invoke the threat of preemption over state law or exclusive federal agency enforcement authority, and the financial institution will likely find an ally to assist in defending the case in its federal depository institution regulator. The prohibition on the FTC bringing UDAP actions against banks should also be rescinded. Together, these actions would create an open UDAP public enforcement system as to financial institutions, which would

123. *See* Brief for Center for Responsible Lending et al., *supra* note 111, at 22-38.

124. GAO REPORT, *supra* note 5, at 59-60; COP REPORT, *supra* note 32, at 33.

have several advantages.

An open UDAP public enforcement model would serve much the same function as marketplace competition. More UDAP enforcement would increase the incentives for financial institutions and their regulators to prevent UDAP actions. Regulators faced with competing UDAP enforcement agencies would have a much greater incentive to pay attention to consumer complaints of unfair or misleading conduct. A different public entity bringing a UDAP action against a financial institution under the purview of the regulator is not a situation that any public agency wants to experience.[125] Focusing regulator attention on this type of knowledge by providing the fear of action by a different public entity would help bring the type of knowledge gained in UDAP enforcement into the core of the financial institution regulatory function.

An open enforcement model increases the number of public agencies that can take action and thus increases the likelihood that some public agency will be interested and available in pursuing needed UDAP enforcement cases. Public agency priorities for UDAP enforcement shift over time with the elected or appointed officials in charge of the agency. During the explosive growth of subprime mortgage lending, the FTC had UDAP authority for actions against FAMCO, Household, and Ameriquest because they were not banks, as well as other non-bank subprime lenders.[126] While the FTC later joined with the states in taking action against FAMCO in 1999,[127] the FTC brought few UDAP actions against subprime lenders thereafter. State attorneys general stepped into the void. Conversely, when the FTC is more active in a certain area, state attorneys general would have less incentive or need to pursue UDAP cases in that area. Giving more agencies UDAP authority over financial institutions would result in more potential for enforcement action.

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125. For a recent example of the problems this poses to public agencies, one need look no further than the recent humiliation of the Securities and Exchange Commission's failure to act in the Madoff case. *See, e.g.*, David Stout, *Report Details How Madoff's Web Ensnared S.E.C.*, N.Y. TIMES, Sept. 2, 2009.

126. *See supra* notes 63 & 88.

127. Kogut Testimony, *supra* note 68, at 5.

The OCC, consistent with the position of regulated financial institutions, objects to multiple public agencies with enforcement authority because of the possibility of inconsistent regulatory requirements.[128] Open UDAP public enforcement would not threaten inconsistency in disclosure requirements, substantive mortgage term requirements or other rule-based regulations. The risk of inconsistency comes in differing views of the various public enforcement entities in enforcing the broad standards prohibiting unfair and deceptive conduct. This is exactly the type of variation that allowed state attorneys general to bring actions against abusive subprime mortgage lending while other public regulators saw "compliance" in these loans. UDAP cases are not easy to initiate or prosecute, and having various standards forces other regulators and the regulated entities alike to pay attention to the critical knowledge gained by concern with UDAP violations.

Finally, open UDAP public enforcement against financial institutions would help address a more subtle form of conflict of interest that exists in the inconsistency between safety and soundness regulation and UDAP enforcement. A financial institution subject to possible or extant lawsuits for violation of UDAP or other consumer protection laws can be financially weakened by such actions. Especially in a substantial UDAP case, this places the depository institution regulator in the position of necessarily defending the institution's practices at issue in order to maximize the institution's soundness, at least in the short run.

One alternative for preventing this result is to separate safety and soundness regulation from UDAP enforcement, but that structure defeats the advantage of combining these different sources of knowledge in the same regulator. An option for avoiding this result is an open UDAP public enforcement model. If state attorney generals, state financial regulators, or the FTC could readily bring UDAP actions against depository institutions or their operating subsidiaries, consumer protection interests would be vindicated. At the same time, it would ensure that the depository institution

128. Brief of All Former Comptrollers of the Currency Since 1973 as Amici Curiae in Support of Respondents at 29-35, Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710 (2009) (No. 08-453), 2009 WL 906571.

regulators would have a more substantial incentive to discover and prevent UDAP violations, in part to protect the safety and soundness of the institution.

IV. Conclusion

A myriad of issues arise in considering the restructuring of financial institution regulation. Enforcement of UDAP laws during the subprime mortgage explosion provided state attorneys general a richer, earlier understanding of what was actually happening in the mortgage market. Whether because of conflicts of interest or regulatory approach, federal depository institution regulators were not in a position to effectively utilize this knowledge in regulating residential mortgage lending. Regulatory reform should ensure that UDAP enforcement as to financial institutions is effective and that the knowledge generated from UDAP actions informs the decision-making of financial institution regulators. Opening UDAP enforcement against financial institutions to public agencies with a history of, and disposition toward, UDAP enforcement would help to achieve this goal.