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Foreword: Perspectives on Mortgage Lending Regulation

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FOREWORD: PERSPECTIVES ON MORTGAGE LENDING REGULATION

*Julie Patterson Forrester**

THE global financial crisis of 2007-2008 thrust mortgage lending regulation to the forefront of discussions by policymakers and legislators. The crisis triggered a global recession, and in the United States, millions of homeowners lost their homes to foreclosure. One cause of the crisis was most certainly a failure of regulation.¹

In reaction to the financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010.² After a period characterized by very little federal regulation of mortgage lending, Dodd-Frank produced a sea change in the regulation of mortgage lending by the federal government.

This symposium examines the new regulatory framework created by Dodd-Frank from different points of view and considers other types of mortgage lending regulation, including regulation at the state and local levels and proposals for macroprudential regulation. Its participants presented papers at the program of the Section on Real Estate Transactions at the Association of American Law Schools Annual Meeting in January of 2016. As its name implies, Dodd-Frank is intended to provide consumer protection and to lessen systemic risk. Professors Kathleen Engel and Christopher Odinet focus on the consumer protection aspects of mortgage lending regulation, while Professor Steven Schwarcz focuses on regulation to reduce systemic risk.

Long before the financial crisis and the enactment of Dodd-Frank, the 1980s began a period of deregulation of mortgage lending and preemption of state consumer financial protection measures that continued into

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1. See U.S. FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMM'N ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE U.S. xviii (2011); KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 149-187 (Oxford University Press 2011); Julie Forrester, *The Subprime Lending Crisis: How Did We Get Here?*, THE QUAD, Vol. 39, p. 37, 40 (2008).

2. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

the beginning of the new century. In 1980, Congress enacted the Depository Institutions Deregulation and Monetary Control Act,³ which preempted state usury ceilings on substantially all mortgage loans secured by a first lien on residential real estate.⁴ Two years later, Congress enacted the Garn-St. Germain Depository Institutions Act, which further deregulated banks and savings and loan associations.⁵ One section of the Act preempted state law regulation of due-on-sale clauses,⁶ and another section, known as the Alternative Mortgage Transaction Parity Act, preempted state laws restricting alternative mortgage transactions, such as adjustable rate mortgages.⁷

Federal agencies also joined in the deregulation game by preempting state measures designed to protect homeowners in mortgage loan transactions.⁸ In 1996, the Office of Thrift Supervision (OTS) issued regulations preempting state laws that affected federal savings associations and their operating subsidiaries.⁹ These regulations preempted state laws governing licensing, credit terms, loan fees, disclosure requirements, origination, and interest rate ceilings.¹⁰ In 2004, the Office of the Comptroller of the Currency (OCC) issued a regulation preempting the application of state laws governing mortgage lending to national banks and their operating subsidiaries.¹¹ The regulation was intended to have the same preemptive effect as the earlier OTS regulation.¹² It preempted state laws governing licensing and registration, insurance requirements, loan-to-value ratios, amortization, payments, loan term, escrow accounts, disclosures, and due-on-sale clauses.¹³ The federal government preempted state consumer financial protection statutes and, at the same time, failed to provide a strong alternative.¹⁴

Many scholars criticized the deregulation of lending institutions and

3. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.).

4. 12 U.S.C. § 1735f-7a(a)(1) (2006).

5. Pub. L. No. 97-320, 96 Stat. 1545 (1982) (codified in scattered sections of 12 U.S.C.).

6. 12 U.S.C. § 1701j-3(b)(1) (2012).

7. 12 U.S.C. § 3803(c) (2006) (amended 2010).

8. See Julia Patterson Forrester & Jerome Michael Organ, *Promising to be Prudent: A Private Law Approach to Mortgage Lending Regulation in Common-Interest Communities*, 19 GEO. MASON L. REV. 739, 749-50 (2012).

9. 12 C.F.R. § 560.2(a) (2005). The regulations were issued pursuant to the Home Owners' Loan Act. See generally 12 U.S.C. §§ 1461-1468.

10. 12 C.F.R. § 560.2(b). The regulation "occupie[d] the entire field of lending regulation for federal savings associations." *Id.* § 560.2(a).

11. Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1917 (Jan. 13, 2004) (codified at 12 C.F.R. § 34.4 (2005)).

12. See 68 Fed. Reg. 46264 at n. 91 (Aug. 5, 2003); News Release, Comptroller of the Currency, OCC Issues Final Rules on National Bank Preemption and Visitorial Powers (Jan. 7, 2004), <http://www.occ.treas.gov/static/news-issuances/news-releases/2004/nr-occ-2004-3.pdf> [<https://perma.cc/7SEU-YWG6>].

13. 12 C.F.R. § 34.4(a) (2011).

14. Forrester & Organ, *Promising to be Prudent*, *supra* note 8, at 750.

federal preemption of state consumer financial protection laws,¹⁵ and many listed the lack of federal oversight as one cause of the crisis.¹⁶ As the crisis unfolded, consumer advocates, lawmakers, and scholars made calls for more stringent regulation of mortgage lending. In 2010, Congress answered that call by enacting Dodd-Frank.

Dodd-Frank addresses numerous aspects of financial regulation, many of which affect mortgage lending. For example, Title III of the Act makes changes to the regulatory framework for banks and thrifts, eliminating the OTS and placing supervision of thrifts under the auspices of the OCC.¹⁷ Title VII regulates derivatives,¹⁸ and Title IX regulates credit rating agencies.¹⁹

Title IX also contains the “skin-in-the-game” rule, which requires a securitizer to retain at minimum a 5% interest in the credit risk of any asset that the securitizer transfers by issuing an asset-backed security.²⁰ An exception to the 5% retention rule exists if the asset-backed security is collateralized only by qualified residential mortgages.²¹

Title X of Dodd-Frank established the Bureau of Consumer Financial Protection (CFPB)²² to regulate consumer financial services, including home mortgages, “for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”²³ The Act gives the CFPB broad regulatory powers to enforce federal consumer financial laws and to make rules to carry out the objectives of those laws.²⁴

Dodd-Frank specifically provides that the CFPB’s powers under federal law do not preempt state consumer financial protection laws that are

15. See, e.g., Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLA. L. REV. 295 (2005); Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303 (2006); Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government’s Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 388 (1994); Cathy Lesser Mansfield, *The Road to Subprime “HEL” Was Paved with Good Congressional Intentions: Usury Deregulations and the Subprime Home Equity Market*, 51 S.C. L. REV. 473 (2000).

16. See, e.g., ENGEL & MCCOY, *supra* note 1, at 149; Forrester, *The Subprime Lending Crisis*, *supra* note 1, at 40.

17. Dodd-Frank § 312(b)(2)(B) (codified at 12 U.S.C. § 5412(b)(2)(B) (2010)).

18. *Id.* tit. VII.

19. *Id.* tit. IX, subtit. C.

20. *Id.* § 941(b) (codified at 15 U.S.C. § 78o-11(c)(1)(B)(i) (2010)); see Steven L. Schwarcz, *Macroprudential Regulation of Mortgage Lending*, 69 SMU L. REV. ____ (2016).

21. Dodd-Frank § 941(b) (codified at 15 U.S.C. § 78o-11(c)(1)(B)(i)(I) (2010)). Note that the qualified residential mortgage is not the same as the qualified mortgage safe harbor discussed in text accompanying *infra* notes 35-37.

22. *Id.* § 1011(a) (codified at 12 U.S.C. § 5491(a) (2010)).

23. *Id.* § 1021(a) (codified at 12 U.S.C. § 5511(a) (2010)).

24. *Id.* § 1022 (codified at 12 U.S.C. §§ 5515, 5564, 5581 (2010)). The Bureau has promulgated many regulations. For example, a newly proposed CFPB rule would prohibit providers of consumer financial products and services from including class action waivers in arbitration provisions in their contracts with consumers. See *Arbitration Agreements*, 81 Fed. Reg. 32830-01 (proposed May 24, 2016) (to be codified at 12 C.F.R. pt. 1040).

more protective,²⁵ and it limits the ability of the OCC to preempt state consumer financial protection laws.²⁶ Thus, states may once again adopt and enforce their own consumer financial protection statutes.²⁷ Furthermore, Dodd-Frank gives states the power to enforce CFPB regulations as well as their own laws.²⁸

Title XIV of Dodd-Frank, known as the Mortgage Reform and Anti-Predatory Lending Act (Mortgage Reform Act), deals specifically with home mortgage lending.²⁹ Its “ability to repay” rule has provoked much commentary.³⁰ The rule requires home mortgage lenders to make “a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms.”³¹ In assessing ability to repay, lenders must consider credit history, income, expected future income, debt-to-income ratio, employment, and assets,³² and must verify these factors by requiring reliable documentation from third parties.³³ Lenders must consider the borrower’s ability to repay a fully amortized loan, even if the loan provides for payment of interest only or for deferral of principal or interest.³⁴

The Mortgage Reform Act creates a safe harbor for lenders regarding the ability-to-repay rule by providing a presumption that a loan meets the ability-to-repay requirements if it is a “qualified mortgage.”³⁵ A qualified mortgage is generally one that does not have certain features that make loans more risky, such as negative amortization, high balloon payments,

25. Dodd-Frank § 1041(a) (codified at 12 U.S.C. § 5551(a)(2) (2010)).

26. *Id.* § 1044(b) (codified at 12 U.S.C. § 5553 (2010)).

27. See Jared Elost, *Dynamic Federalism and Consumer Financial Protection: How the Dodd-Frank Act Changes the Preemption Debate*, 89 N.C. L. REV. 1273, 1302 (2011).

28. Dodd-Frank § 1042(a)(1) (codified at 12 U.S.C. § 5552(a)(1) (2010)).

29. *Id.* tit. XIV (codified in scattered sections of 15 U.S.C.).

30. See, e.g., Amanda Brett Etheridge, *Too “Qualified” or Not “Qualified” Enough? Criticism and Suggested Reforms to the Currently Ineffective “Qualified Mortgage” Standards*, 19 J. CONSUMER & COM. L. 17 (2015); Kevin P. Diduch, *Close, But No Cigar: How the Ability to Repay Rule Creates a “Disparate Impact” on the American Dream*, 43 REAL EST. L.J. 298 (2014); Patrick T. O’Keefe, Note, *Qualified Mortgages & Government Reverse Redlining: How the CFPB’s Qualified Mortgage Regulations Will Handicap the Availability of Credit to Minority Borrowers*, 21 FORDHAM J. CORP. & FIN. L. 413 (2016); David Reiss, *Message in a Mortgage: What Dodd-Frank’s “Qualified Mortgage” Tells Us About Ourselves*, 31 REV. BANKING & FIN. L. 717 (2012).

31. Dodd-Frank § 1411 (codified at 15 U.S.C. § 1639c(a)(1) (2015)). In addition, the borrower must have a reasonable ability to pay insurance premiums, taxes, and other assessments. *Id.*

32. *Id.* (codified at 15 U.S.C. § 1639c(a)(3)). The CFPB issued regulations to flesh out these requirements. See *Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 6408, 6461 (codified at 12 C.F.R. § 1026.43(c)(2) (2016)).

33. Dodd-Frank § 1411 (codified at 15 U.S.C. § 1639c(a)(4)); 12 C.F.R. § 1026.43(c)(3), (4).

34. Dodd-Frank § 1411 (codified at 15 U.S.C. § 1639c(a)(6)).

35. *Id.* § 1412 (codified at 15 U.S.C. § 1639c(b)(2)(A)). Professor Odinet details the requirements for a qualified mortgage. Christopher K. Odinet, *The Unfinished Business of Dodd-Frank: Reforming the Mortgage Contract*, 69 SMU L. REV. 653. CFPB regulations flesh out the requirements and provide for two different levels of lender protection for qualified mortgages. See 12 C.F.R. § 1026.43(e).

high points and fees, and that also meets certain underwriting standards.³⁶

In addition to the ability to repay rules and the qualified mortgage safe harbor, the Mortgage Reform Act has a provision that is designed to prevent lenders from steering borrowers to more expensive loans by prohibiting fees that vary based on any loan term other than principal amount.³⁷ The Mortgage Reform Act also restricts prepayment penalties³⁸ and includes other new prohibitions and disclosure requirements.³⁹

Dodd-Frank has become a political lightning rod, with Democrats praising it and Republicans threatening its repeal.⁴⁰ It has also generated significant scholarly commentary.⁴¹ A number of commentators have hailed Dodd-Frank as a positive step in protecting consumers and the market.⁴² Others have criticized Dodd-Frank on the basis that it swings the pendulum too far in the direction of mortgage regulation,⁴³ that it does not go far enough,⁴⁴ that it adopts the wrong approach to regula-

36. See *id.* For a discussion of the characteristics of risky loans, see Forrester, *Promising to be Prudent*, *supra* note 8, at 751-52, and for a discussion of the characteristics of predatory loans see Forrester, *Still Mortgaging*, *supra* note 15, at 1312-13. A qualified mortgage may have a balloon payment under certain circumstances. See 12 C.F.R. § 1026.43(f).

37. *Id.* § 1403 (codified at 15 U.S.C. § 1639b(c)(1)).

38. *Id.* § 1414 (codified at 15 U.S.C. § 1639c(c)).

39. See generally *id.*

40. See Cheyenne Hopkins, Carter Dougherty & Silla Brush, *Banks May Have Overplayed Their Hand Fighting Wall Street Regulation*, BLOOMBERG (Feb. 11, 2015), <http://www.bloomberg.com/news/articles/2015-02-11/banks-swaps-win-gives-elizabeth-warren-upper-hand-on-dodd-frank> [<https://perma.cc/7BCR-UVQ4>]; Zach Carter, *Second Verse, Same as the First: Republicans Prepare Another Dodd-Frank attack*, HUFFINGTON POST (Jan. 13, 2015), http://www.huffingtonpost.com/2015/01/12/republicans-dodd-frank-attack_n_6459722.html [<https://perma.cc/S5NG-TUZ8>].

41. A recent search on Westlaw generated more than 400 articles with “Dodd-Frank” in the title, although some of the articles deal with aspects of Dodd-Frank not related to mortgage lending regulation.

42. See, e.g., ENGEL & MCCOY, *supra* note 1, at 236, 252 (“Dodd-Frank takes bold steps toward protecting consumers.”) (“Ultimately, Dodd-Frank is a mixed bag, containing some failures and some successes.”); Leonard J. Kennedy, Patricia A. McCoy & Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 CORNELL L. REV. 1141 (2012); Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243, 1325 (“Overall, Dodd-Frank is a substantial step in the right direction, but additional steps still need to be taken.”).

43. See *Over-regulated America*, THE ECONOMIST (Feb. 18, 2012), <http://www.economist.com/node/21547789> [<https://perma.cc/PTU4-YF2G>]; Peter J. Ferrara, *How Over Regulation is Killing the Economy*, IBD (Apr. 27, 2016), <http://www.investors.com/politics/viewpoint/how-overregulation-is-killing-the-economy/> [<https://perma.cc/QTW4-G2MJ>].

44. See, e.g., Murdock, *supra* note 42, at 1325 (“Overall, Dodd-Frank is a substantial step in the right direction, but additional steps still need to be taken.”); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to Fail Problem*, 89 OR. L. REV. 951 (2011).

tion,⁴⁵ or that it too severely limits the availability of credit.⁴⁶

The participants in this symposium view Dodd-Frank and other mortgage lending regulation through various lenses. Professor Kathleen Engel focuses on local government regulation of mortgage lending.⁴⁷ She looks at attempts made at the local, state, and federal levels of government to prevent abusive lending practices through legislation as well as litigation.⁴⁸ She explains that efforts by cities to regulate lending were struck down because they fell outside the scope of authority of a local government,⁴⁹ whereas lawsuits faced the hurdle of establishing standing.⁵⁰ She argues that efforts by states and the federal government prior to Dodd-Frank were simply insufficient.⁵¹ Cities have been somewhat more successful after the fact in addressing problems of blight and abandoned homes caused by the foreclosure crisis because courts and legislatures have been more likely to find these problems within the powers of local governments.⁵² Professor Engel argues that that local governments should be given the power to regulate mortgage lending,⁵³ and that cities can fill the enforcement gap if given the standing to litigate.⁵⁴ Finally, Professor Engel makes specific proposals for expanding the powers of local governments to regulate mortgage lending, to address blight, and to sue.⁵⁵

Next, Professor Christopher Odinet takes a new look at the Fannie Mae/Freddie Mac uniform residential mortgage instrument in the context of the current regulatory environment.⁵⁶ He begins by reviewing the history of standardization of the mortgage instrument and the benefits of the uniform instrument to consumers and participants in the secondary market.⁵⁷ He then turns to a discussion of home mortgage finance before and after Dodd-Frank. He examines the role of the CFPB in protecting homeowners and the operation of the ability-to-repay rule and the qualified

45. See, e.g., Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles: How Mortgage Regulation Can Keep Main Street and Wall Street Safe—From Themselves*, 163 U. PENN. L. REV. 1539 (2015); Wilmarth, *supra* note 44, at Pt. V.

46. See, e.g., Diduch, *supra* note 30; O'Keefe, *supra* note 30. Professor Patricia McCoy defends the ability-to-repay rule. Although mortgage credit is too tight today, Professor McCoy points out that lenders had stopped making risky loans even before the ability-to-repay rule took effect. Professor McCoy discusses the reasons for this overcorrection in the credit market and ways to increase access to safe mortgage credit. *2015 AALS Annual Meeting Podcasts*, ASSOC. AMERICAN LAW SCHOOLS, <https://www.aals.org/aals-events/am-media/2015-aals-annual-meeting-podcasts/>.

47. Kathleen C. Engel, *Local Governments and Risky Home Loans*, 69 SMU L. REV. 609 (2016).

48. *Id.* at Pt. II.

49. *Id.* at subpt. II.B.1.

50. *Id.* at subpt. II.B.3.

51. *Id.* at subpts. II.C & D.

52. *Id.* at subpt. III.B.

53. *Id.*

54. *Id.* at subpt. IV.B.

55. *Id.* at Pt. V.

56. Odinet, *supra* note 35.

57. Odinet, *supra* note 35, at subpts. I.B & C.

mortgage safe harbor,⁵⁸ noting that more than 98% of new home mortgage loans were qualified mortgages in the fourth quarter of 2015.⁵⁹ He discusses recent abuses by servicers of the rights to inspect and secure homes.⁶⁰ Professor Odinet concludes that because of the more stringent underwriting process mandated by Dodd-Frank, homeowners are less likely to default on their mortgage obligations, making certain provisions of the uniform mortgage unnecessary.⁶¹ He discusses and recommends changes to three specific provisions be changed: the lender's right to inspect, escrow requirements, and the lender's right to secure the property.⁶²

Lastly, Professor Steven Schwarcz focuses on macroprudential mortgage lending regulation—regulation focused on reducing systemic risk—rather than on microprudential regulation, which is intended to increase economic efficiency by correcting market failures.⁶³ He discusses two particular proposals for ex ante macroprudential regulation—the “skin in the game” requirement of Dodd-Frank, which requires securitizers to retain some of the credit risk for securities that they sell,⁶⁴ and a proposal that lenders be required to overcollateralize mortgage loans.⁶⁵ Because he concludes that ex ante macroprudential regulation cannot completely alleviate systemic risk,⁶⁶ he also discusses whether ex post macroprudential regulation could be effective. He discusses the possibility of a privately-funded governmental liquidity provider to create a financial safety net⁶⁷ and the disruption of transmission chains relating to housing and housing finance.⁶⁸ He concludes by discussing where mortgage lending and its regulation fit in the overall picture of systemic risk.⁶⁹

Mortgage lending regulation promises to continue to be an important topic of discussion because the bursting of a housing bubble can significantly impact the health of the economy. In my thirty years of involvement with real estate finance, I have watched real estate cycle through boom and bust and mortgage credit cycle through periods of tighter and looser underwriting standards. Only time will tell if current levels and types of regulation will prevent abusive lending practices and lessen sys-

58. Odinet, *supra* note 35, at subpt. II.B.

59. Odinet, *supra* note 35, at 678 (citing National Association of Realtors, *Seventh Survey of Mortgage Originators 2015*, 2 (Aug. 17, 2015), <http://www.realtor.org/reports/august-2015-mortgage-originators-survey>).

60. Odinet, *supra* note 35, at subpt. III.A.

61. Odinet, *supra* note 35, at 686.

62. Odinet, *supra* note 35, at subpt. III.C. On the other hand, Professors Engels and McCoy “advocate mandatory escrow accounts for the life of all home loans” to protect borrowers from unexpected tax bills and the risk of a tax foreclosure. ENGEL & MCCOY, *supra* note 1, at 229.

63. Schwarcz, *supra* note 20, at 597.

64. Schwarcz, *supra* note 20, at 598; *see also supra* notes 20-21 and accompanying text discussing the “skin-in-game” rule.

65. Schwarcz, *supra* note 20, at 600 (citing Bubb & Prasad, *supra* note 45).

66. Schwarcz, *supra* note 20, at 603.

67. Schwarcz, *supra* note 20, at 603-04.

68. Schwarcz, *supra* note 20, at 604-05.

69. Schwarcz, *supra* note 20, at 606.

temic risk. The scholarly commentary provided by Professors Engel, Odinet, and Schwarcz can help inform policymakers and legislators about measures designed to protect against another crisis.